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Frequently asked questions on the restructuring of the Spanish banking sector

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CONTEXT

1 Why is the Spanish banking sector undergoing a restructuring process coordinated by the national and international authorities?

To understand why the Spanish banking sector is undergoing a restructuring process coordinated by the national and international authorities, it is necessary to understand the background and economic context of recent years.

In the past three years, the Spanish authorities have adopted a series of important measures in an attempt to correct these problems and restore confidence in the banking sector. Among others, the measures include the clean-up of bank balance sheets, the increase in minimum capital requirements, the restructuring of the savings bank sector, the significant increase in provisioning requirements for loans earmarked for real estate developments and real estate assets, the increase in the information provided by banks to the markets, particularly regarding their exposure to the real estate development and construction segments and in relation to the stress tests conducted by the European Banking Authority (with around 90% of the banking system participating, compared with the required minimum of 50%). The measures, however, have not sufficed to ease the pressure of the markets, which have continued to have misgivings about the quality of the assets on bank balance sheets and about banks' level of solvency.

With a view to restoring confidence in the solvency of Spanish banks and to determining the level of capital that will ensure their long-term viability, the Council of Ministers, by means of the Resolution dated 11 May 2012, entrusted the Ministry of Economic Affairs and Competitiveness to prepare an external analysis, of an aggregate nature, to **evaluate the resilience of the Spanish banking sector to a further sharp deterioration in the economy**.

The Banco de España, in coordination with the Ministry of Economic Affairs and Competitiveness, hired independent international specialists for the analysis of potential capital needs under a highly stressed macroeconomic scenario (stress tests).

The 14 biggest Spanish banking groups (once the integration processes currently under way are taken into account) participated in this exercise, accounting for around 90% of the assets of the Spanish banking system.

The independent valuation of the Spanish banking system comprises two main areas of work: an initial top-down analysis followed by a subsequent and more detailed bottom-up analysis.

On 21 June, the independent consultancies hired, namely Roland Berger and Oliver Wyman, published their reports with the results of the exercise (based on a top-down methodology), considering two different macroeconomic scenarios: first, a so-called baseline scenario, which is considered the most likely to occur on the basis of estimates considered to be prudent, and second an adverse scenario, which assumes a further sharp deterioration in the Spanish macroeconomic situation. This latter scenario is considered very unlikely to occur (its statistical probability is around 1%) and envisages declines in GDP of 4.1%, 2.1% and 0.3% in 2012, 2013 and 2014, respectively.

The rationale for considering such an extreme scenario is to examine the resilience of the Spanish banking system, not only under normal conditions, but also in very adverse situations.

The aim of this first exercise, of an aggregate nature, was to give an overall capital figure for the whole of the Spanish banking system. The analysis was top-down, insofar as the information used enabled a sufficiently precise estimate to be made for the whole of the banking system, but was not sufficiently granular to provide for individual bank estimates.

The results of the tests conducted, which were a first and extensive exercise in transparency, determined recapitalisation needs of between €16 billion and €26 billion under the baseline scenario, and between €51 billion and €62 billion under the adverse scenario, for all the banks considered.

In parallel with this exercise, each bank was audited in order to conduct a detailed and individualised analysis of the credit portfolios of the 14 banking groups. These audits comprised a review of the quality of the data, proper accounting classification, potential provisioning shortfalls, etc. To perform this work, four audit firms of international repute (Deloitte, PwC, Ernst & Young and KPMG) were hired.

The heightening international pressure on Spanish debt and the need to offer guarantees to the markets about the viability of the banking system led the Spanish government, on 25 June 2012, to request external financial assistance in the context of the ongoing **restructuring and recapitalisation of its banking sector**. This financial assistance of up to €100 billion was agreed by the Eurogroup on 20 July and included in the Memorandum of Understanding (MoU) approved by the national and European authorities, in the context of the assistance programme mentioned.

A key component of the programme is an overhaul of the vulnerable segments of the Spanish banking sector, which comprises the following three elements:
Identification of individual bank capital needs through a comprehensive asset quality review of the banking sector and a bank-by-bank stress test, based on a highly stressed hypothetical macroeconomic scenario.

Recapitalisation, restructuring and/or resolution of the least viable banks, based on plans to address any capital shortfalls identified in the stress test.

Segregation of impaired assets in those banks receiving public support for their recapitalisation and their transfer to an external asset management company.

The first of these elements, determining the capital needs for each bank (bottom-up approach), was a natural extension of the (top-down) work set in train by the independent consultancies, involving an examination and a more detailed analysis that included an exhaustive and itemised valuation of the credit portfolios of each bank.

This second work stage, whose results are presented today, was entrusted to Oliver Wyman. Integrated into this stage were both the conclusions and analysis of the exhaustive and itemised valuation of Spanish credit portfolios, performed by four audit firms of international repute (Deloitte, PwC, Ernst & Young and KPMG), and the results of the independent valuations of real estate assets made by six appraisal companies with extensive experience in both the national and international arena. The entire process was coordinated by the Banco de España, overseen by the *Expert Coordination Committee* (EEC) and the *Strategic Coordination Committee* (SCC), and assisted and advised by The Boston Consulting Group. The audit and valuation work, which began in late May, ran to end-August and was primarily intended to provide essential information for the disaggregated exercise.

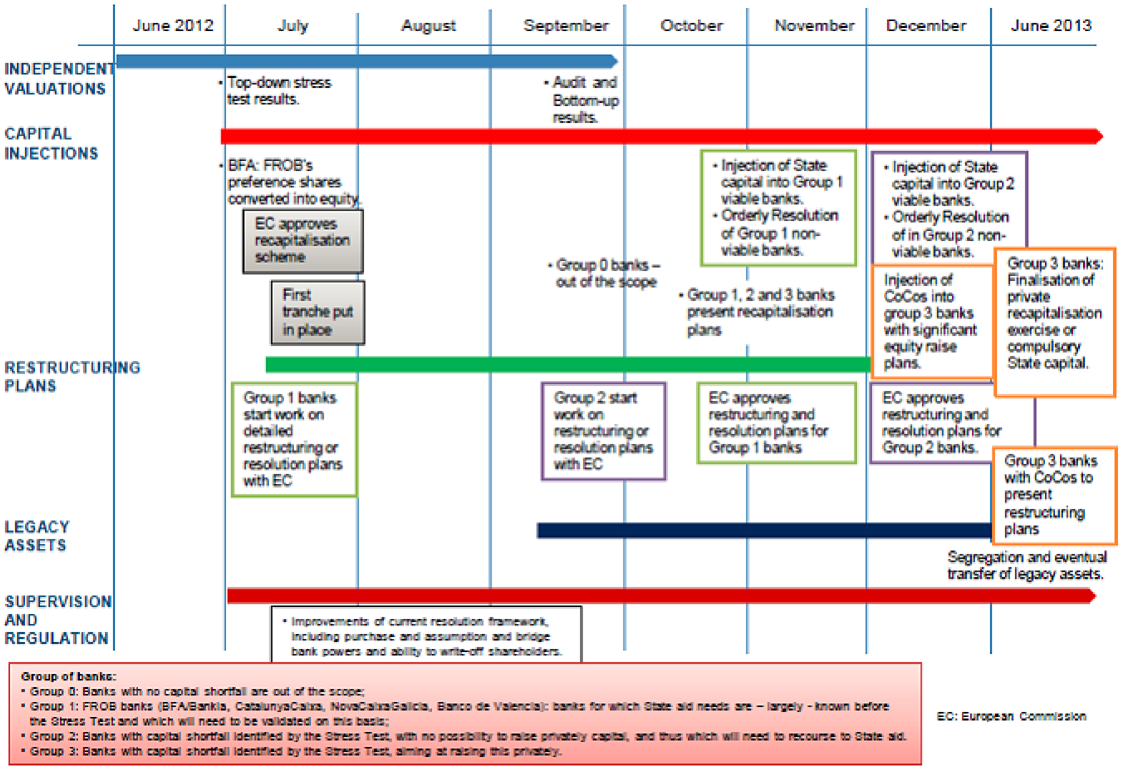
It is precisely the results of this bottom-up stress test exercise that are being published today, 28 September, in keeping with the schedule set in the roadmap laid down in the MoU (second half of September).

2 What are the main landmarks of the Spanish banking sector restructuring process?

The Spanish banking sector restructuring process comprises the following work stages (see the accompanying figure):

- Independent valuation (top-down and bottom-up analysis).
- Formulation of recapitalisation plans of banks with a deficit over the minimum capital requirement set in the stress test.
- Review of these plans by the authorities and classification of the banks into the groups established in the MoU.
- Transfer of the troubled assets of the banks that require State aid to the Asset Management Company for Assets Arising from Bank Restructuring (AMC) envisaged for these purposes in the recent Royal Decree-Law 24/2012 of 31 August 2012.
- Provision of State aid to banks.
- Supervision and regulation.

Restructuring of the Spanish Banking Sector: Timeline



As of today, the work relating to the independent valuations has concluded. The banks at which capital needs have been detected in the bottom-up exercise must submit the related recapitalisation plans during the second half of October to cover in part or in full the capital needs estimated. As part of these plans, capital will be injected into those banks that cannot cover their capital needs by their own means or by tapping the markets, and impaired assets will be transferred to an asset management company, as envisaged in the MoU.

In a parallel with the previous measures and with a view to ensuring an effective and swift recapitalisation of the Spanish banking sector, the regulatory framework in place has been progressively improved. One key component of the regulations governing bank restructuring and resolution can be found in Royal Decree-Law 24/2012 of 31 August 2012. This reinforces the current Spanish legislation in this area, providing the public authorities with new instruments and bank restructuring and resolution powers.

3 What does the independent valuation process consist of? How does it square with the MoU signed with the European Union?

The independent valuation process is the first phase of the Spanish banking sector restructuring programme, which is included in the Memorandum of Understanding (MoU) signed with the European Union. The independent valuation has been satisfactorily completed today, 28 September.

The Banco de España, in coordination with the Ministry of Economic Affairs and Competitiveness, decided to hire **independent international specialists** to analyse the potential capital needs under a highly stressed macroeconomic scenario (stress tests).

These analyses comprised an initial top-down stress test, the results of which were published on 21 June, and a second, more detailed bottom up stress test, the results of which are published today, 28 September.

4 Which parties are involved in this process?

The parties involved in the Spanish banking sector restructuring process are as follows:

- National authorities: Banco de España, Ministry of Economic Affairs and Competitiveness and FROB.
- International authorities: European Commission (EC), European Central Bank (ECB), European Banking Authority (EBA) and the International Monetary Fund (IMF).
- Independent experts: including the independent consultancies (Oliver Wyman and Roland Berger) and leading audit firms (Ernst & Young, KPMG, PwC and Deloitte).
- Appraisal companies: Tinsa, Valtecnic, Gesvalt-Madiva, Aguirre Newman, Jones Lang LaSalle and CB-Richard Ellis.
- Project management support: The Boston Consulting Group (BCG).
- The credit institutions, by providing the information required for the process.
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5 What has been the role of the national and international authorities?

The Banco de España, together with the Ministry of Economic Affairs and Competitiveness, has cooperated thoroughly with the international authorities (EC/ECB/EBA/IMF) throughout the process.

The Banco de España lead-managed the work performed in the independent valuation, while continuously in contact with the national and international authorities, coordinating the work of the four audit firms and the external consultancies so as to ensure that the valuation is of the highest quality and homogeneity, given the number of institutions taking part.

The Ministry of Economic Affairs and Competitiveness and the international authorities acted as supervisors and coordinators of the whole independent valuation process and are present at the various levels of the steering committees that have been created (ECC and SCC).

Strategic management and decision-taking was performed jointly by the national and international authorities through a governance structure that has supervised the process and involved both parties.

6 Which governance structure has overseen the process?

The MoU established a governance structure in order to ensure that the work performed would be carried out to the highest possible quality by applying a single methodology consistently and uniformly to all participating groups. The governance structure has comprised: international authorities (EC, ECB, EBA and IMF) and national authorities (Banco de España, Ministry of Economic Affairs and FROB). This governance structure has two levels and the above-mentioned international and national authorities are represented at both levels:

- The Expert Coordination Committee (ECC). The ECC has analysed in detail the state of the exercise, reviewed documentation and results, received explanations on the implementation of the various intermediate stages of work and validated the main hypotheses that have enabled the exercise to be consistent and credible and to be completed within the timetable established in the MoU.
- Strategic Coordination Committee (SCC). The SCC has been responsible for taking the strategic decisions necessary for the exercise to be successfully concluded, eventually approving its final results.

The structure defined reflects the commitment of the international and Spanish authorities to the process of recapitalisation and restructuring of the Spanish banking system.

7 Why was it necessary to hire independent experts for the implementation of the Independent Valuation process?

In order to resolve doubts over Spanish banks' solvency and to determine the level of capital that ensures their long-term viability, the Council of Ministers, further to the Resolution of 11 May 2012, instructed the Ministry of Economic Affairs and Competitiveness to prepare an external aggregate analysis to evaluate the resilience of the Spanish banking sector in the face of an additional deterioration in the economy. This commitment to employ independent experts is also included in the Memorandum of Understanding (MoU) signed on 20 July with the European Union, and specifies the characteristics of the bottom-up and asset valuation exercise.

Throughout this process the Spanish authorities have benefitted from the view of independent experts with extensive experience of macroeconomic factors that affect the outlook for economic growth potential and of the performance of stress tests.

Since the exercise involves independent experts, it has taken on a more international perspective.

The external experts meet a series of requirements to ensure their independence. Additionally, they have the advantage of the experience of their head offices.

8 Which independent experts have taken part in the bottom-up exercise? What has their function been?

The independent experts that have participated in the preparation of the exercise are Oliver Wyman; the audit firms Ernst&Young, KPMG, PwC and Deloitte; and the consultancy, The Boston Consulting Group. Six real estate appraisal companies have also taken part:

- Oliver Wyman: this consultancy was responsible for conducting the stress tests, designing the calculation models and, ultimately, estimating the preliminary capital needs of the banks under the two scenarios covered. For this purpose, Oliver Wyman has used the results of the work performed by the main audit firms in Spain.

- Audit firms (Ernst&Young, KPMG, PwC and Deloitte): the four largest audit firms were responsible for performing an independent accounting valuation of the credit portfolio and, additionally, a review of banks' NPL management systems. The assignment of the audit firms to the banking groups can be found in Annex II to the "*Background Note*" published today.
- Appraisal companies: Tinsa, Valtecnic, Gesvalt-Madiva, Aguirre Newman, Jones Lang LaSalle and CB-Richard Ellis.
- The Boston Consulting Group (BCG): BCG has supported the Banco de España in coordinating the work between the four largest audit firms and the external consultancy, Oliver Wyman, ensuring that the exercise was homogeneous across the participating institutions and that the deadlines were met.

9 What is a stress test? What is the difference between a top-down and a bottom-up exercise?

A stress test is a theoretical exercise used to forecast what could happen to a group of banks under a series of hypothetical macroeconomic assumptions.

The objective of the stress tests is to estimate the capital needs that the banks would require to maintain a specific capital ratio under said scenarios.

The scenarios considered in the stress tests are defined in such a way that they are possible from an economic standpoint and that they cover a specific timeframe. Generally, stress tests comprise several scenarios which include a "baseline" and an "adverse" or extreme scenario.

Stress tests, like other economic analyses, can be conducted using the top-down methodology with aggregate data, or following a bottom-up methodology with disaggregated data:

- Top-down methodology: the aggregate or top-down analyses draw on system-level data (with some breakdown at bank-level but without being sufficiently granular or in-depth) and generally apply techniques and concepts uniformly to all the units that make up a system. The top-down models are frequently designed with the help of system-level assumptions that permit calculations to be performed at that level but do not explain the individual components in detail.
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- Bottom-up methodology: the disaggregated or bottom-up analyses draw on more detailed data at the individual level of each of the units that make up a system. The individual calculations are designed in detail and are subsequently aggregated so as to provide the system-level results. These models are generally more accurate and reliable since they use individualised data which guarantees greater precision. Noteworthy among the other information is the loan-by-loan inventory of the banking book and of foreclosed assets as well as the business plans.

The Spanish banking sector was analysed using both approaches: the top-down analysis which was published 21 June and the bottom-up analysis published today.

10 Why have two different stress tests (the top-down analysis in June and the bottom-up analysis in September) been conducted on the Spanish banking groups

In order first to specify the range of possible capital needs for the Spanish banking system, in an aggregate fashion, the top-down analysis was conducted, whose results were published on 21 June. Notably, the precision of this exercise, though high, does not provide for an estimate of capital needs bank-by-bank. It was important to define as promptly as possible the range of aid that the banking system as a whole was going to require.

However, it was essential under the roadmap defined for the recapitalisation and restructuring of the banking system to determine the capital needs of each bank with a sufficient level of precision. To perform the bottom-up exercise, an independent and detailed accounting review of banks' credit portfolios was necessary, requiring greater dedication in terms of the resources and time assigned to the exercise. The results of this exercise, owing to its advanced methodology, are more precise and enable bank-by-bank needs to be estimated. This is why the conducting of this latter exercise has needed more time.

11 What is the definition of "capital needs"? what is the capital ratio (Core Tier 1)? why is it important for the stability of the Spanish banking system?

The capital or Core Tier 1 ratio is a solvency indicator that measures a bank's financial health. The capital ratio measures, as a percentage, the relationship between core capital (funds provided by the shareholders and reserves) and risk-weighted assets. A "high" capital ratio denotes that the bank has sufficient capacity to withstand eventual losses in the course of its business.

The Core Tier 1 ratio is the most demanding of those used, since it only includes own funds of the highest quality in its numerator. This ratio is stricter than the BIS II ratio and the current Spanish “capital principal” ratio.

The capital or "Core Tier 1" ratio has become an international standard in similar exercises and is used to set the minimum level of solvency that banks should meet under the macroeconomic scenarios designed.

The Spanish banking system and the banks that make it up should be capable of maintaining capital ratios above the minimum levels agreed Europe-wide. Ensuring the solvency of Spanish banks is of vital importance since that ensures the stability of the Spanish banking system.

"Capital needs" are defined as the difference between the minimum capital required by the capital ratios set in each scenario and the capital estimate resulting from the stress test for each bank.

It should be underscored that the results published today are not final capital needs or the public aid that each bank will need, since the process will continue with the presentation of the recapitalisation plans in October (see the reply to Question no. 2).

12 What is the difference between the capital needs identified in the stress test exercise and public aid needs?

The estimated capital needs included in the Oliver Wyman report will, in general, be lower than the amounts of public aid needed to recapitalise the banks. The difference between both (resulting capital need and final public aid) will be determined by the various measures that the banks incorporate into their recapitalisation plans, which can be summarised in the following categories:

- Disposal of assets on the market.
- Raising of capital that may be obtained privately on the markets.
- Transfer of assets to the Asset Management Company (AMC).
- Conducting of loss-assumption exercises by the holders of hybrid or subordinated instruments under Royal Decree-Law 24/2012.
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13 How does this stress test compare with other tests recently performed in other areas?

This test has focused on the credit portfolio in Spain of the 14 group selected, given the growing concern of the markets over the solvency and quality of the banking system.

Most of the differences between the stress tests conducted in Spain and those carried out internationally are due to the greater exhaustiveness applied in the Spanish exercise. Specifically:

- 15 macroeconomic factors have been considered (as opposed to the maximum of 10 used in other tests, except in the case of Ireland), such factors being the most significant of the Spanish economy (e.g. land prices, financial data of the Madrid stock exchange).
- The time horizon spans a period of three years (from 2012 to 2014), compared with the two years envisaged in most of the other tests conducted, except in the case of Ireland. Considering a three-year scenario means that the economic recession lasts longer, which increases the potential losses of the banks analysed, and their potential capital needs.
- It includes much more adverse assumptions than the other tests conducted to date. In particular, the tests conducted in Spain assumes a greater deterioration of all factors: a continuous recession over three years, a fall in GDP of 6.5% over this period, a 5.6% increase in the unemployment rate, and house and land prices and the extension of credit all fall over the three years, and more markedly so in the adverse scenario.
- The capital ratios set in this stress test are more demanding than those seen in other similar tests (e.g. 5% and 8% in the adverse and baseline scenarios in the latest EBA exercise).

14 Which banks have participated in the bottom-up exercise?

The Spanish banking system's 14 main banking groups have participated in all of the process relating to the stress test. The list of these groups is as follows:

- Santander Group (includes Banesto)
- BBVA Group (includes UNNIM)
- Caixabank (includes Banca Cívica)
- Bankia-BFA
- Sabadell Group (includes CAM)
- Popular-Pastor España Group
- Novagalicia Banco
- Liberbank – Ibercaja – Caja3
- Bankinter
- Kutxabank
- Catalunya Caixa
- Banco Mare Nostrum
- Unicaja-CEISS
- Banco de Valencia

The results of the mergers already announced and under way (Liberbank–Ibercaja–Caja3 and Unicaja-CEISS) will additionally be presented individually.

15 Why have not all banks present in the Spanish market been included in the exercise?

The independent evaluations of the banks entail a series of processes and work which require a high allocation of both economic resources and time, which advise against including all banks present in the Spanish market.

Significantly, the banks included in the exercise account for approximately 90% of the Spanish banking system, covering most of the sector and allowing conclusions to be drawn about the entire sector.

For the remaining banks that have not been included and of which an independent evaluation has not been made, the control mechanism is based on the continuous supervision of the Banco de España.

16 Which portion of the banks' assets has been included in the stress test exercise ?

The stress test exercise has been performed on the business credit portfolios in Spain of the 14 participating banking groups, which account for 90% of the Spanish banking system.

It is on the quality of these portfolios that the growing concern of the market has been focused.

METHODOLOGY

17 Why is the bottom-up report published today the most reliable on the market?

This exercise is the most reliable one on the market. Since it is bottom-up it uses much more granular and accurate information than market exercises (which are always top-down and do not have so much information available to them).

In recent weeks, various reports by investment banks and analysts have been published, which apparently replicate the methodology of Oliver Wyman. The results of these reports differ from the ones presented today for the bottom-up tests, which may give rise to uncertainty as to which report is the most accurate or reliable.

Given this situation, the Banco de España wishes to clarify that only Oliver Wyman has had access to the information used during the process (Banco de España databases, results of independent valuations of auditors, credit inventories and foreclosed assets, transaction by transaction, banks' business plans, etc.) and therefore their results are more reliable and certain.

18 What methodology has been used in the bottom-up exercise?

The capital needs of a bank depend on the amount of losses it can bear while still meeting the required capital ratios at the end of each period. There are thus two main components:

> **1** Losses on the credit portfolio: to calculate the losses on banks' credit portfolios a model has been developed for each type of asset projecting future losses on the basis of macroeconomic factors such as GDP, the price of housing, rates of unemployment and 13 additional factors. To these factors are applied the scenarios defined by the ECC/SCC. The methodological framework used is consistent with the Basel credit risk methodology, with the estimation of parameters for probability of default and loss given default.
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> **2** Loss absorption capacity: existing provisions, asset protection schemes, surplus capital (relative to 9% under the baseline scenario and 6% under the stressed scenario) and the capacity to generate profits. In the latter case, business in Spain (for which a detailed analysis and stressing has been performed for each scenario) has been distinguished from international business (for which a 30% adjustment has been applied to the attributed profit – after provisions and taxes).

19 What are the main inputs and outputs of the bottom-up exercise?

Various sources of information have been used to carry out the project:

- The Banco de España, including, for example, loans and receivables databases (more than 36 million transactions), monthly databases of the Central Credit Register (CIR) going back to 1989, accounting statements –

in particular the Credit Risk Distribution (CRD) table, financial statements, ...-.

- Banks, including, for example, databases of foreclosed assets (more than 350,000 assets), real-estate property sales (more than 110,000 sales since 2009), detailed information on collateral, business plans, etc.
- Auditors, from four independent firms, including, for example, the validation of the initial information (CRD and loans and receivables databases), review of cases focusing on the identification of potential effects not reflected in the accounting information (e.g. reclassifications from standard to doubtful and between CRD items, restructurings, etc.).
- Independent real-estate appraisers, with experience of the Spanish market, with a review of more than 1.7 million dwellings, mixing residential assets and complexes, as well as 8,000 assets through automatic and manual valuation systems.

The main results of the exercise are as follows:

- Bottom-up loss projection, through an economic assessment of the individual loan/asset, with specific emphasis on the areas of greatest risk.
- Estimation of the loss absorption capacity, through a structural analysis and projection of the capacity to generate profits of the banks subject to the exercise.
- Bank-level capital needs, through evaluation of the capital excess/shortfall with respect to requirements of the different banks under the stress test performed.

20 How has the auditors' work been incorporated into this exercise?

The ultimate aim of the work performed in this area has been to serve as one of the inputs used to calculate capital needs bottom-up, with all the results of the audit work integrated into the exercise. Specifically, the following exercises and analyses have been carried out for each of the banking groups, consisting of both extensive reviews of the whole loan portfolio and of samples of borrowers and transactions required for the purpose:

- Analysis of the quality of the data of the whole census of loans and receivables transactions, including:

  - Matching up inventories with accounting records.
  - Reliability of the value of the collateral incorporated, especially the updating and quality of appraisals.
  - Correct identification of refinanced transactions.

- Appropriate classification of the portfolio in accordance with the situation of the borrower, value of collateral and sector. Verification of the credit risk distribution (CRD) table in order to review the correct segmentation of risk operations and their accounting status and the type of collateral related to them, covering all the CRD segments (developers, construction, large firms, SMEs, individuals' mortgages and other exposures to individuals).

- Checks on additional provisions, calculated by the bank, required by Royal Decree-Law 2/2012 and Royal Decree-Law 18/2012, based on the portfolio as at 31 December 2011.
- Evaluation of the calculation by automatic-NPL-treatment of the provisions required by accounting regulations.
- Itemised analysis of a sample of cases of borrowers so as to reach a conclusion regarding their correct accounting classification and the sufficiency/insufficiency of the provisions recorded by the banks as at 31 December 2011 for such borrowers.

All this work has enabled Oliver Wyman, among other matters: to adjust the initial CRD incorporating the figure for developer risk which was misclassified in other segments; to adjust the figure for refinancings, to refine those parameters of credit quality that are not directly observable in the banking book information or the historical data of each bank. All this reinforces the thoroughness and granularity of the analysis carried out by Oliver Wyman in the bottom-up stress tests.

21 How has homogeneity of treatment of the banks in the exercise been ensured?

Given the nature and composition of the exercise, the ECC, the Banco de España and the supporting external consultants (BCG) have given crucial importance to homogeneity of treatment across the participating banks.

The exhaustive monitoring imposed by the management of the project, together with the definition of shared terms of reference with a single, consistent set of guidelines, has ensured that the exercise has been performed homogeneously by the audit firms, and all the banks included in the scope have been treated equitably.

22 What scenarios have been used?

Two different macroeconomic environments have been considered: first, a so-called baseline scenario, which is considered the most likely to occur on the basis of estimates considered to be prudent, and second an adverse scenario, which assumes a further sharp deterioration in the Spanish macroeconomic situation. This latter scenario is considered very unlikely to occur (its statistical probability is around 1%) and envisages declines in GDP of 4.1%, 2.1% and 0.3% in 2012, 2013 and 2014, respectively.

The rationale for considering such an extreme scenario is to examine the resilience of the Spanish banking system, not only under normal conditions, but also in very adverse situations.

The following table details the main variables used in the baseline and adverse scenarios, both in the top-down and bottom-up exercises, for 2012-2014:

Macroeconomic scenarios 2012-2014

			Baseline			Adverse		
		2011	2012	2013	2014	2012	2013	2014
GDP	Real GDP	0.7	-1.7	-0.3	0.3	-4.1	-2.1	-0.3
	Nominal GDP	2.1	-0.7	0.7	1.2	-4.1	-2.8	-0.2
Unemployment	Unemployment rate	21.6	23.8	23.5	23.4	25.0	26.8	27.2
Price changes	Harmonised CPI	3.1	1.8	1.6	1.4	1.1	0.0	0.3
	GDP reduction factor	1.4	1.0	1.0	0.9	0.0	-0.7	0.1
Real estate sector	House prices	-5.6	-5.6	-2.8	-1.5	-19.9	-4.5	-2.0
	Land prices	-6.7	-25.0	-12.5	-5.0	-50.0	-16.0	-6.0
Interest rate	EURIBOR, 3 months	1.4	0.9	0.8	0.8	1.9	1.8	1.8
	EURIBOR, 12 months	2.0	1.6	1.5	1.5	2.6	2.5	2.5
	Sovereign debt, 10 years	5.6	6.4	6.7	6.7	7.4	7.7	7.7
Exchange rates	USD / EUR exchange rate	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Loans to Other Resident Sectors	Households	-1.5	-3.8	-3.1	-2.7	-6.8	-6.8	-4.0
	Non-financial corp.	-3.6	-5.3	-4.3	-2.7	-6.4	-5.3	-4.0
Stock exchange indices	Madrid Stock Exchange Index	5.6	6.4	6.7	6.7	7.4	7.7	7.7

23 Who defined the macroeconomic scenarios?

The macroeconomic scenarios and core Tier 1 capital requirements were decided upon by the Strategic Coordination Committee (SCC) and the Expert Coordination Committee (ECC); both of which consisted of the Ministry of Economic Affairs and Competitiveness, the Banco de España and the FROB, as well as by the European Commission, the European Central Bank (ECB), the European Banking Authority (EBA) and the International Monetary Fund (IMF).

These scenarios are the same as those approved for use in the top-down exercise by the Steering Committee and Advisory Panel, in which the same national and international authorities participated.

24 Why has a 9% capital ratio been used in the baseline scenario and a 6% ratio been used in the adverse one? What ratios have been used in other similar exercises?

In any stress test different capital ratios must be set for the baseline scenario and for the adverse scenario. This is because the macroeconomic conditions defined in the adverse scenario reflect highly stressed macroeconomic conditions with a very low probability of occurrence.

The capital ratios set in this stress test are more demanding than those in other similar tests (for example, 5% and 8% in the adverse scenarios) and comply with the Basel III regulations which require banks to meet a common equity ratio of 4% by the end of 2014.

25 Why is the stress test time horizon three years?

The stress test performed in Spain covers a period of three years (2012-2014), while most other tests consider a two-year horizon (Portugal, EBA, etc.). The prudential capital assessment review (PCAR) performed in Ireland also covered a three-year period, from 2008 to 2010 (but, unlike in the Spanish case, the final year was not one of recession).

Considering a three-year scenario allows for the possibility that the economic recession will last longer than in other similar stress tests, which increases the potential losses of the banks analysed, and their possible capital needs, making the analysis performed more exacting.

26 How reasonable are the scenarios and the hypotheses considered in the exercise? Why is the adverse scenario not even more adverse? What is the probability that these scenarios will occur?

The design of the scenarios perfectly meets the overall objective of the exercise of checking the resilience of Spanish banks in extremely adverse market and macroeconomic situations.

Oliver Wyman's analysis demonstrates that the scenarios used in Spain are probably the most adverse of all those used in banking sector stress tests in recent years at the global level. Moreover, in the case of other markets the adverse scenario was applied at the start of the crisis, while in Spain an even more adverse scenario has been applied after four years of economic deterioration and crisis.

The adverse scenario considered in the stress test represents a case of extreme deterioration in economic activity in Spain, so that its use lies in checking the capacity of banks to withstand severe but very unlikely economic shocks.

The probability of occurrence of the adverse scenario is extremely low (statistically around three standard deviations relative to the macro parameters of the last 30 years in Spain). In any case, using recognisable magnitudes the probability of occurrence is less than 1%.

By way of example, the adverse scenario considers a fall in GDP of more than 4% in 2012. However, in view of the developments in the first half of the year and the evolution of indicators in Q3, such a decline is almost impossible. The latest average forecast of a group of analysts and institutions (such as that considered in Consensus Forecasts) is for a fall in GDP of 1.6% in 2012. Even the most pessimistic of the institutions included in that publication regarding growth in 2012 forecasts a decline in GDP (of 2%) that is only half as large as the one simulated in the adverse scenario. Moreover, it should be taken into account that the decline in activity in the first year is the most relevant shock for the purposes of the exercise, since it places the level of Spanish output well below its most reasonable level over the whole of the projection horizon.

The adverse scenario posits a cumulative fall in GDP of 6.5 percentage points over the period 2012-2014. This would make this new recessionary phase more severe than the 2008-2010 one, when GDP fell by around 5%. In that phase, the drastic adjustment of residential investment played a fundamental role, but this adjustment (which has almost been completed) could not now be repeated.

Most analysts forecast a cumulative GDP decline in Spain over the period 2012-2014 of around 2 percentage points, so that the adverse scenario involves three times this loss of output. In these conditions it is hard to believe that the adverse scenario should be even more severe. The probability of occurrence of a scenario of this type, judged in terms of historical macroeconomic forecasting errors, is very small. It is true that these historical errors may partially reflect periods when there was less volatility than at present, but even taking that into account the probability of the adverse scenario is still low.

27 How has the bottom-up exercise taken into account the trends and behaviour of the spanish economy?

The starting point taken for the stress test is the situation of the Spanish banking sector at December 2011. The related balance sheets are subjected to two scenarios with different stress levels during the years 2012, 2013 and 2014. The Spanish economy is performing better in the first half of 2012 than envisaged in the scenarios used. However, given that the objective of the exercise is to check the resilience to a 3-year period of stress, no results from the first half of 2012 have been incorporated. The alternatives to incorporating them into the stress test would have been to project the same three years of stress using the June 2012 data or to assume a sharper deterioration in the second half of the year so as to bring the 2012 stress conditions into line with the parameters used in the stress test.

28 What is the initial capital level used to calculate the additional capital needs in the bottom-up exercise?

The initial capital level is the core tier 1 capital at 31 December 2011 using the definition given in the stress test conducted by the EBA. Additionally, account has been taken of any non-core actions (those not related to ordinary operations) performed up to 31 August 2012 which may have had an impact on that capital base. All the information has been provided and confirmed by the Banco de España.

29 Have asset protection schemes (APSs) been taken into account in the stress test? How?

Yes, the losses on portfolios protected by APSs have been analysed in detail and the effect of the coverage by each APS has been included as additional loss absorbing capacity.

30 How has the capacity of banks to absorb losses been estimated? What type of leverages and/or actions able to generate increases in capital have not been taken into account?

The capacity to absorb losses is determined by the following:

- Existing provisions. Those recorded at international subsidiaries are not taken into account for absorbing losses in operations in Spain.
- Asset protection schemes at the banks to which they have been granted.

- Net operating income before provisions from operations in Spain projected for 2012-2014 plus profit after taxes from international operations, to which a haircut of 30% has been applied.
- Capital measures implemented in the first half of 2012.
- Capital in excess of the minimum levels of 9% and 6% under the baseline and adverse scenarios, respectively.

Capital actions planned by banks but not implemented have not been taken into account.

RESULTS

31 What results are presented today?

The report published today, 28 September, on the Banco de España website gives the results of the (bottom-up) stress tests conducted between July and September, as stipulated in the Memorandum of Understanding (MoU).

The capital needs indicated in this report do not necessarily coincide with the government assistance to be received by banks, which will be set by the Banco de España and the European Commission. The possible differences will stem from the need to consider various actions which may be taken by banks, scheduled for approval by the authorities in October, to reduce their final capital needs and from those actions set out in the MoU and incorporated into Royal Decree-Law 24/2012.

32 Will banks have to comply with the capital needs under the baseline scenario or the adverse scenario? Why?

The results of the bottom-up stress tests include the capital needs under the baseline scenario and under the adverse scenario. For the sake of prudence, the higher of the two will be taken.

33 What is the difference between the results before and after taxes? Do the results consider deferred tax assets (DTAs)?

Under the tax and accounting regulations, the financial statements used to determine capital needs must reflect the related tax assets and liabilities. Therefore both losses and projected net operating income have been taken into account in determining DTAs.

The main differences between the results before and after taxes are as follows:

- Taxes: those banks able to generate profits in any year in the specified time horizon will be subject to a tax rate of 30%.
- Generation of DTAs: those banks with a loss in any of year in the time horizon are deemed to generate additional DTAs equal to 30% of their loss. This does not apply to Group 1 banks (those controlled by the FROB) because it is considered that those banks will be unable to use the DTAs under the stress test scenario.
- Basel 3: additionally, the conservative criterion of the Basel 3 transitional arrangements was taken into account when judging the compatibility of DTAs in the 2014 capital base
  - DTAs arising from prior year losses (net of deferred tax liabilities): deduction of 20% of the capital base.
  - DTAs arising from temporary differences (net of deferred tax liabilities): deduction of 20% of the amount which exceeds 10% of the capital base.

34 At what level do the international authorities approve the results of this stress test?

The International Authorities (EC/ECB/EBA/IMF) have supervised and coordinated the whole process of independent evaluation, have been present at the various levels of the steering committees (ECC and SCC) and, lastly, have endorsed, along with the Spanish authorities, the final results of the stress tests.

35 Are the stress test results published today definitive? Why not?

No.

The capital needs indicated in this report do not necessarily coincide with the government assistance to be received by banks, which will be set by the Banco de España and the European Commission. The possible differences will stem from the need to consider various actions which may be taken by banks, scheduled for approval by the authorities in October, to reduce their final capital needs. These actions may be summarised as follows:

- Disposal of assets held by banks.
- Raising any capital that may be obtained privately on the markets.
- Transfer of assets to the asset management company (AMC).
- Implementation of loss-absorbing exercises by the holders of hybrid instruments.

36 When will the final capital needs of each bank be published?

The final capital needs will be known following assessment of the stress test results presented today and the recapitalisation plans to be submitted in the coming weeks by those banking groups in which capital needs have been detected. The exact date of publication is not known and will depend on the preparation of the recapitalisation plans and their subsequent approval.

37 Who determines the final capital needs?

The Spanish authorities and the European Commission will assess the viability of the banks on the basis of the stress test results and the banking groups' recapitalisation plans to be submitted in the next few weeks determining the final capital needs.

38 In what cases will government assistance be necessary? What processes and requirements will have to be fulfilled by banks to receive government support?

The banks which will require government assistance are still not known, although we can rule out those banking groups for which no capital needs were detected in the stress test, which will naturally not need any aid.

On the basis of the stress test results presented today and the recapitalisation plans to be submitted by those banking groups which have been identified in the stress test as having capital needs, banks will be classified into **four Groups**:

- **Group 0** is made up of those banks for which no capital shortfall has been detected. No subsequent measures will be required.

- **Group 1** is composed of those banks in which the Fund for the Orderly Restructuring of the Banking Sector (FROB) already has a majority holding.
- **Group 2** will include banks with a capital shortfall identified by the stress test and unable to meet those capital shortfalls privately by their own means without State aid. This government assistance may only be provided within the framework of a bank restructuring or resolution process in accordance with Royal Decree-Law 24/2012 of 31 August 2012. For this purpose, viable banks requiring government assistance for their recapitalisation or those banks whose resolution would seriously harm the banking system will be restructured, while the other non-viable banks will be resolved in an orderly manner as stipulated by Royal Decree-Law 24/2012.
- **Group 3** will be made up of those banks which have a capital shortfall identified by the stress test but have reliable recapitalisation plans and are able to meet that capital shortfall by their own means. Within this group, those banks with capital needs exceeding 2% of risk-weighted assets (RWA) will have to issue, by 31 December 2012, bonds compulsorily convertible into shares which will be subscribed by the FROB and will have to be redeemed by 30 June 2013.

The Banco de España and the European Commission will be responsible, upon a prior report from the FROB, for approving the plans submitted. The FROB will submit to the Ministry of Economic Affairs and Competitiveness and the Ministry of Financial Affairs and Public Administration an economic report with details of the financial impact which the plans submitted will have on the funds provided out of the State budget.

OTHER QUESTIONS

39 In light of the results, what are the consequences for banks?

Following the results published today, two cases may be distinguished:

- Banking groups in which no capital needs have been identified: these banking groups will be excluded from the rest of the exercise and will not have to submit recapitalisation plans. They will form Group 0.
- Banking groups in which capital needs have been identified (Groups 1, 2 and 3): these banking groups will continue with the procedures described in the Memorandum of Understanding (MoU) and will have to submit a recapitalisation plan in the next few weeks to cover the capital needs detected.

40 What are the next steps for each group?

Once the banks have been classified, the Spanish authorities and the European Commission will evaluate their viability on the basis of the stress test results and the recapitalisation plans submitted:

- Viable banks which require public support for their recapitalisation and banks that cannot be resolved without serious harmful effects on the banking system must draw up a restructuring plan.
- Banks that are considered non-viable and non-systemic shall be resolved in an orderly manner in accordance with the terms of the relevant resolution plan.

The Banco de España and the European Commission will be responsible, upon a prior report from the Fund for the Orderly Restructuring of the Banking Sector, for approving the resolution and/or restructuring plans submitted. The FROB will submit to the Ministry of Economic Affairs and Competitiveness and the Ministry of Financial Affairs and Public Administration an economic report with details of the financial impact which the plans submitted will have on the funds provided with a charge to the State budget.

Regarding **Group 1** banks, the Spanish authorities have been working on the restructuring or resolution plans, in conjunction with the European Commission, since end-July 2012. These plans will be finalised in light of the stress test results and will be submitted in time for the Commission to approve them in November 2012. On this basis, State aid will be granted and the envisaged plans can be implemented immediately. The process of moving impaired assets to the AMC will be started by year-end. Also, the loss assumption exercises will be required of hybrid capital holders for Group 1 banks (in general, for all banks requiring public support).

Regarding **Group 2** banks, the Spanish authorities will have to submit a restructuring or resolution plan to the European Commission in October 2012 at the latest. Given the need to incorporate the stress test results, the approval process will foreseeably extend up to the end of December, when these banks will be recapitalised or resolved in an orderly manner. All Group 2 banks must include in their restructuring or resolution plan the necessary steps to segregate their impaired assets into the AMC.

Public support will be granted, if appropriate, to Group 1 and 2 banks as soon as the Commission approves the related plans, following the procedure agreed in the Financial Assistance Facility Agreement. Thus, after funds have been requested for each bank, the European Financial Stability Facility (EFSF) – or, once it becomes operational, the European Stability Mechanism (ESM) – will verify compliance with all the requirements for disbursement and will forward its proposal in this respect to the Euro Working Group (EWG) for approval. This proposal will take into account the specific national factors needed for consent to be given by each Member State. The Commission has to review compliance with the conditionality agreed in the MoU and issue a report which will be taken into consideration by the EFSF for these purposes. This review will take place in the second half of October. Once the operation has been approved, the EFSF/ESM will transfer to the FROB the related funds for the FROB to inject them into the specific bank in exchange for those securities (ordinary shares or convertible bonds) that may be decided.

Regarding **Group 3** banks, two cases are distinguished:

- The **Group 3** banks planning a **significant capital increase** equal to 2% or more of risk-weighted assets will, as a precautionary measure, be required to issue contingent convertible securities (COCOs) under the recapitalisation scheme to meet their capital needs by end December 2012 at the latest. The COCOs will be subscribed by the FROB using programme resources and can be redeemed until 30 June 2013 if the banks succeed in raising the necessary capital from private sources. Otherwise they will be recapitalised through the total or partial conversion of the COCOs into ordinary shares. The banks will have to present restructuring plans.
- The **Group 3** banks planning a **more limited capital increase** of less than 2% of risk-weighted assets will have until 30 June 2013 to carry it out. Should they not succeed, they will be recapitalised by means of State aid and will have to present restructuring plans.

The Group 3 banks that still benefit from public support under this programme on 30 June 2013 will be required to envisage in their restructuring plans the transfer of their impaired assets to the AMC, unless it can be shown, for banks requiring less than 2% of risk-weighted assets in State aid, that other means to achieve full off-balance sheet segregation are less costly.

41 Do these results mean that the Spanish Banking Sector will not generate profits in the next three years?

No.

The results presented today in the bottom-up stress tests are only estimates under theoretical scenarios. Consequently, they do not correspond to banks' internal estimates.

The profits generated by the Spanish Banking Sector over the next three years will depend on developments in their activity and in the variables which make up the actual economic scenario that could be different to the theoretical scenarios designed for Oliver Wyman's bottom-up exercise.

42 What is the relationship between the stress tests and the Asset Management Company (AMC)?

The stress tests estimate the banks' capital needs, which may be covered in different ways. One of these ways is the sale of assets or their transfer to the AMC which, since it reduces banks' assets, it will also reduce their capital needs. Furthermore, the transfer of assets to the AMC will have an additional benefit which is to definitively remove the assets, whose solvency has been questioned, from the banks' balance sheets and to isolate the impairment risk of these assets, by dispelling any doubts about the solvency of the banking system as a whole.

Lastly, the estimates made by Oliver Wyman in relation to the value of the real estate assets will be a point of reference when setting the transfer price to the AMC.

43 How do these results affect ordinary customers of banks with identified capital needs?

The results published today do not directly affect any customers of the banks considered in the exercise.

The banks which have participated in the exercise will continue to operate normally and their usual operations will not be affected.

44 How do these results affect the holders of hybrid products (for example "preference shares")?

The Memorandum of Understanding (MoU) on financial assistance approved on 20 July requires, as part of the specific conditionality for the banking sector, the undertaking of Subordinated Liability Exercises (SLEs) for all banks receiving public support.

The requirement in relation to SLEs arises from the principles of European Union regulations on State aid, which require the creation of mechanisms for the burden-sharing of the restructuring between public funds, which ultimately are provided by Spanish and European taxpayers as a whole, and the holders of capital and hybrid instruments issued by the banks which are actually receiving the financial assistance. (This requirement has been incorporated into Spanish law through Royal Decree-Law 24/2012 of 31 August 2012).

The burden-sharing principle only affects the holders of shares, preference shares and subordinated debt of banks receiving public support. The level of loss absorption of each instrument will be proportional to their degree of subordination and the level of public support required by each bank. It will have greater impact on banks requiring more substantial support and it will also have a greater effect on shareholders than on holders of preference shares and subordinated debt.

At banks receiving an injection of public capital, these SLEs may involve the exchange of hybrid instruments (preference shares and subordinated debt) for capital instruments of the issuer bank, an exchange which, as required by the European Commission, will be performed taking into account their market value.

The SLEs are not detrimental to the possibilities of action by and compensation of the interested parties in cases of fraudulent marketing of preference shares and other hybrid instruments.

45 Will the shares continue to be listed even if the State has a majority stake?

This will depend on the size of the aid which the bank has to request and its final use. If the size of the aid means that the State's holding is close to 100%, the bank will possibly not continue to be listed on the markets. If it is finally used for the orderly resolution since it is not viable or systematic, delisting will take place as part of the resolution process.

Nonetheless, there are cases in which, although the government has a majority stake in the bank, the shares will continue to be listed on the market. For example, the UK government acquired 65% of Lloyds in March 2009 and the shares continued to listed regularly on the stock market. Ultimately, this depends on the regulations governing the stock market where the bank is listed.

46 How could these results affect lending?

These results strengthen the perception that our banking system is sound and solvent in two ways. On one hand, they clearly differentiate between strong credit institutions and weaker ones which may need additional capital. Thus, a problem of asymmetrical information is resolved, which resulted in the potential risk of certain institutions being perceived as a risk of the Spanish banking system as a whole, by reaffirming the soundness of solvent institutions which are the majority. But, furthermore, those weaker banks are also going to benefit from the publication of these results. On one hand, the results that have been published, although they are generally as envisaged, they definitively put an end to the uncertainty about the capital needs of a series of institutions. On the other, the publication of these results is accompanied by a specific and credible roadmap for their recapitalisation.

All of this is going to have a positive effect on banks' access to funding and on the financing cost of our banking system which will foreseeably decrease in the medium term. A banking system with better access to funding has greater incentives to lend in the interests of increasing its returns. And, an adequate flow of credit is a prerequisite for investment and economic growth.

MEMO

This document answers questions that have been raised by analysts and market participants following the release of the results of the Asset Quality Review and Bottom-Up Stress Test exercise results on Friday 28th September.

1 What is the capital buffer and how does it work?

The “capital buffer” is the difference between a bank’s Common Equity Tier 1 (CET1) and the projected minimum capital required for that bank in each of the base and adverse scenarios that were specified by the Expert Coordination Committee (“ECC”) and the Strategic Coordination Committee (“SCC”).

The minimum capital required in each scenario has been calculated by applying the scenario-specific capital level thresholds defined by the ECC and the SCC (9% in the base case; 6% in the adverse case) to the estimated level of Risk Weighted Assets (RWAs) in that scenario at the end of 2014. Note that estimated RWA levels are different in each scenario as the levels of credit portfolio write-offs, loan amortization and new loan origination over the three-year period are different in each scenario.

In the estimation of a bank’s capital needs in each of the base and adverse scenarios, the capital buffer is the last loss absorption component that gets depleted by projected losses.

2 Why does the stress test use a 6% capital level threshold in the adverse scenario?

Post-scenario capital level thresholds have been defined by the ECC/SCC, composed of representatives of the Banco de España, the Ministerio de Economía y Competitividad, the European Banking Authority, the European Commission, the European Central Bank and the International Monetary Fund.

The rationale behind the lower capital level threshold in the adverse scenario vs base scenario, rests on the lower probability of the former (statistically less than 1%). In that situation, an additional worsening of conditions is extremely unlikely. Since the aim of capital is to cover unexpected losses, and the probability of having additional losses at that point is lower, so are the capital needs required under the adverse scenario.

Note that this capital level is above minimum Basel III regulatory requirements in 2014 (4%) as well as other recent stress testing exercises (5% minimum threshold in US or EBA).

3 Why do capital surpluses increase for some banks under the adverse scenario?

The main reason is the lower post-scenario capital level thresholds of 6% set for the adverse scenario (vs. 9% in the base scenario). For some banks, the increase in losses in the adverse scenario is more than offset by the lower capital level threshold in that scenario.

4 Which are the key drivers of RWA reduction in each scenario, with the resulting "deleveraging" of the balance sheets of some of the entities?

The RWA reduction occurs because it is assumed that there are write-downs of the portfolio (defaulted loans that are written off progressively), amortization of existing loans (which continue to be paid off over time) and reduction in the level of new loan origination. The deleveraging does not assume large scale loan sales.

Note that the ECC/SCC defined overall constraints for the degree of credit reduction in each of the two scenarios split between credit to households and credit to the non-financial corporate sector.

5 Why does the stress test use 3 years of pre-provisioning profit (PPP)?

The time horizon of the exercise has been defined by the ECC/SCC.

While the three-year horizon leads to higher cumulative PPP than a two-year horizon (unless the entity is in loss) and therefore higher loss absorption capacity, it also increases credit losses as the third year in the adverse scenario is also recessionary. The net is that the three-year test is a tougher test for the system than one with a two-year horizon, generating additional capital needs.

6 How were projected losses estimated across entities?

Projected losses were estimated using the credit book information at loan and entity level. The applied model was transversal for the Spanish system, so that each entity has different projected losses because each bank has a different mix of segments and different characteristics of the portfolio.

7 Why do mergers improve the overall projections in the adverse scenario for those affected?

There are two main reasons for this:

- Some of the individual entities involved in the merger are projected to have a capital surplus in the business combination as a result of the accounting rules, which oblige to record some assets at fair value. Those rules are compulsory under international accounting rules (IFRS) at the time of a merger. When the consolidated view is estimated, the surplus from these entities is used as additional loss absorption capacity to cover losses from the merger partner(s) which are projected to have pre-merger capital shortfalls.
- Synergies of the combined entity, due mainly to costs savings

8 Why are mortgages' projected losses lower than in other markets?

See figure 28 (page 37) of the report for further details

There are two important differences between retail mortgage portfolios in Spain when compared to some other countries:

- Foreclosed loans have already been removed from the retail mortgage books. These are typically included as part of the retail mortgage credit book in other geographies.
- If estimated losses from foreclosed loans are added to the overall projection for retail mortgage loss levels, the estimated total loss level would rise to 5.5% as a percentage of 2011 exposures, or €34 BN in total projected losses.
- Average Loan To Value (LTV) levels in Spain (62%) are lower than those observed in other geographies, and LTV is a key driver of retail mortgage credit losses. Credit losses in the Spanish retail mortgage segment amount to ~5.5% (when foreclosed housing assets are included) Those losses would increase to 7.4% if the average LTV in Spain was 80%; or to 8.9% if the average LTV in Spain was 100% (levels observed in other markets.
- Additionally, under Spanish rules, debtors are responsible to pay off their debts with all their present and future goods, which is different from other markets.

9 Which are the Basel III requirements that have been contemplated in the stress test?

Only Basel III Deferred Tax Assets ("DTA") treatment has been considered, as this is the most relevant for Spanish banks. No further Basel III requirements have been assumed.

Basel III capital requirements are not part of the analysis. Capital thresholds in each scenario were defined by the ECC and SCC. Basle III capital requirement for 2014 is set at 4%.

10 Is it possible to have higher projected pre-provisioning profit (PPP) in the adverse scenario?

Yes, it is possible though not common for this to be the case for an individual banking entity. Higher Euribor rates have a positive effect in the adverse scenario, as most of the assets of Spanish banks have variable rates, while some liabilities have fixed rates (e.g. sight deposits). This effect can increase projected PPP.

However, across the banking system as a whole, this small positive effect is more than offset by the reduced projected PPP level due to the shrinking of the balance sheet through credit write-downs and amortization.

11 Are earnings generated in the first half of 2012 considered in the projected pre-provisioning profit?

No, they are not. The stress test's PPP estimates are the result of applying the defined macroeconomic scenarios to each bank with a starting point of December 2011. The objective of the stress test exercise was to assess the resilience of each entity to withstand adverse macro-economic and market conditions in the three-year period 2012 - 2014.