FINANCIAL STABILITY REPORT

05/2014

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Eurosistema

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ABBREVIATIONS (*)

€	Euro
AIAF	Asociación de Intermediarios de Activos Financieros (Association of Securities Dealers)
ABCP	Asset-backed commercial paper
ATA	Average total assets
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BLS	Bank Lending Survey
bn	Billions
bp	Basis points
CBE	Banco de España Circular
CBSO	Banco de España Central Balance Sheet Data Office
CCR	Banco de España Central Credit Register
CDO	Collateralised debt obligation
CDS	Credit Default Swap
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CIs	Credit institutions
CNMV	Comisión Nacional del Mercado de Valores (National Securities Market Commission)
CPSS	Basel Committee on Payment and Settlement Systems
DIs	Deposit institutions
EAD	Exposure at default
EBA	European Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
EONIA	Euro overnight index average
EPA	Official Spanish Labour Force Survey
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
FASB	Financial Accounting Standards Board
FROB	Fund for the Orderly Restructuring of the Banking Sector
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSR	Financial Stability Report
FVC	Financial vehicle corporation
GAAP	Generally Accepted Accounting Principles
GDI	Gross disposable income
GDP	Gross domestic product
GVA	Gross value added
GVAmp	Gross value added at market prices
IASB	International Accounting Standards Board
ICO	Instituto Oficial de Crédito (Official Credit Institute)
ID	Data obtained from individual financial statements
IFRSs	International Financial Reporting Standards
IMF	International Monetary Fund
INE	National Statistics Institute
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
LGD	Loss given default
LTROs	Longer-term refinancing operations
LTV	Loan-to-value ratio (amount lent divided by the appraised value of the real estate used as collateral)
m	Millions
MiFID	Markets in Financial Instruments Directive
MMFs	Money market funds
NPISHs	Non-profit institutions serving households
NPLs	Non-performing loans
OMT	Outright Monetary Transactions

(*) The latest version of the explanatory notes and of the glossary can be found in the November 2006 edition of the *Financial Stability Report.*

OTC	Over the counter
PD	Probability of default
PER	Price earnings ratio
pp	Percentage points
RDL	Royal Decree-Law
ROA	Return on assets
ROE	Return on equity
RWA	Risk-weighted assets
SCIs	Specialised credit institutions
SMEs	Small and medium-sized enterprises
SIV	Structured investment vehicle
SPV	Special purpose vehicle
SSM	Single Supervisory Mechanism
TA	Total assets
TARP	Troubled Asset Relief Program
VaR	Value at risk
WTO	World Trade Organisation

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OVERVIEW

International financial markets have shown notable stability in recent months, interrupted temporarily by certain specific bouts of tension, and have continued to operate in an environment of high liquidity. In the euro area the ongoing improvement in financial market conditions has continued and the financial stress indicators have carried on falling. However, a high degree of financial fragmentation persists, prompting significant heterogeneity in financing conditions within the area.

In Spain, the credit risk premia on securities issued by financial and non-financial corporations continued to decline, as did yields on sovereign debt (ten-year yields stood below 3.1% at end-April 2014) and the related spread over the German benchmark. In the last two quarters of the year GDP posted positive quarter-on-quarter growth rates, an improvement which was mirrored at year-end by the first quarter-on-quarter increase in employment (in seasonally adjusted terms) since 2008. The latest available projections point to this path of gradual recovery continuing.

With regard to the banking sector, the financial assistance programme entered into by the Spanish and European authorities was successfully concluded in January 2014. As a result of the measures taken under the programme in the past 18 months, bank solvency and liquidity has been strengthened as has the regulation and supervision of the industry. Furthermore, progress has continued to be made in recent months on the construction of the Banking Union.

It is against this background, marked by the incipient recovery of the real economy on one hand and improved financial conditions albeit with uncertainty and a high degree of fragmentation in the euro area on the other, that activity in the banking sector has unfolded in recent months. Lending to the resident private sector in business in Spain has continued to diminish, although since mid-2013 there have been signs of the pace of contraction stabilising, breaking the steepening decline that had been observed since early 2011. This decline in lending, which affects both households and firms, and is relatively widespread across the different sectors of activity, is influenced by the economic situation (which remains weak, despite the fact growth has resumed), the necessary deleveraging of households and firms, and the still-high fragmentation in the euro area.

Under credit to the resident private sector, non-performing loans (NPLs) have continued to increase in respect both of households and of non-financial corporations. Along with the continuing decline in credit, this has prompted an increase in NPL ratios over the past year. This increase has been relatively widespread in terms of the different borrowers and sectors of activity, although appreciable differences remain as regards levels, with the ratio for individuals significantly lower than that for corporations. The recent rise in ratios is, partly, the outcome of the refinanced loans portfolio review exercise requested by the Banco de España. Moreover, it should be borne in mind that these indicators reflect developments in the business cycle with some lag. From this standpoint, their rising trend would be expected to continue until the economic recovery firms.

Reflecting the improved conditions on financial markets have been the continuing low levels of the systemic risk indicators for Spain and the continuous decline in the gross recourse by Spanish banks to the Eurosystem. The deposits of households and non-financial corporations

increased over the course of 2013, although the latest available figures suggest an easing in their growth rate. This, combined with the continuing decline in lending to households and firms, will lead the ongoing correction in the retail financing gap to continue.

The banking sector posted consolidated net profit attributable to the group of more than €11 billion in 2013, in contrast to the sizeable losses recorded the previous year. The improvement can be seen both at banks that received State aid and at the rest, and it can be explained mainly by the lower provisions made last year compared with the extraordinary provisioning drive the previous year. Net interest income declined, chiefly as a result of the reduction in activity and, especially, of low interest rates. That poses a challenge for banks, which must persevere with their policies to adjust operating costs and secure efficiency gains.

Capital ratios were strengthened in 2013, both at institutions subject to recapitalisation and restructuring and at other banks.

Chapter 3 of this report presents a study of the impact on bank lending of the broadening of the definition of SMEs and the reduction in capital requirements associated with this type of financing. Secondly, the macroprudential instruments included in CRD IV/CRR are described, along with the latest measures by the European Systemic Risk Board in this area. Finally, Chapter 3 reports on the latest progress in connection with the Single Resolution Mechanism.

In short, the intense process of Spanish banking sector reform continued in 2013 in the context of the financial assistance programme entered into by the Spanish and European authorities, which successfully concluded in January 2014. Both processes, combined with some improvement in the economic outlook, have been conducive to an increase in confidence and to a more favourable market perception of Spanish banks, reflected in a substantial rise in their share prices and in their price-to-book value. However, given that euro area financial markets have not yet fully normalised and in light of the still-incipient economic recovery, the picture remains difficult for the banking sector; factors of pressure on banks' income statements persist and advise they persevere with strengthening their operational efficiency and the conservation of their capital.

1 MACROECONOMIC RISKS AND FINANCIAL MARKETS

Since the last FSR international financial markets have shown notable stability, temporarily interrupted by specific bouts of tension

Since the publication of the last Financial Stability Report, international financial markets have shown notable stability, which has been interrupted on several occasions by specific bouts of tension. Such was the case in late January, with the origin in the emerging economies, and more recently in connection with the crisis in Ukraine. The former episode in January was shorter and more limited than that observed in May further to the discussion on the US Federal Reserve's exit strategy. Accordingly, the markets continue to operate in a setting of high liquidity, in which the uncertainty stemming from monetary policy decisions appears to be limited (despite the fact US monetary stimuli have begun to be withdrawn) and in which the main doubts concern the situation of certain emerging countries that may have built up excessive imbalances.

In the euro area, market conditions have continued to improve, although a high degree of financial fragmentation persists

In the euro area, the indicators of tensions have continued to fall. However, a sizeable degree of fragmentation on European financial markets persists, meaning that financing conditions evidence a high degree of heterogeneity within the area. This has taken place in a setting in which the ECB Governing Council has further eased its monetary policy stance, with a fresh 25 bp cut in November in the interest rates on the main refinancing operations and on the marginal lending facility, leaving them at 0.25% and 0.75%, respectively. The ECB reiterated its intention to hold official interest rates at their current levels, or lower should it prove necessary, for a prolonged period of time. As regards liquidity-providing measures, it decided to extend its fixed-rate auction with full allotment procedure in its refinancing operations for as long as necessary, and at least until mid-2015. In parallel, during this period the financial assistance programmes for Ireland and Spain were successfully concluded, and further progress was made in constructing the Banking Union.

Against this background, yields rose on the highest-rated sovereign debt and fell in the European countries most affected by the tensions. Spanish 10-year government bond yields stood at end-April close to 3%, the lowest level since October 2005. Stock market indices rose across the board in the advanced countries. In the emerging economies there was a greater degree of heterogeneity

Against this background, long-term government bond yields progressively increased in the developed economies with a higher debt credit rating, although their level appears to have stabilised since the start of the year, and there has even been something of a decline (see Charts 1.1.A and B). In contrast, in the euro area countries most affected by the tensions, sovereign debt yields and the related spreads over the German benchmark have narrowed. In particular, in the case of Spanish government debt, which was upgraded by two rating agencies in recent months, the spread of the 10-year bond over the related German benchmark narrowed from 240 bp in late October 2013 to less than 155 bp at end-April, with the yield standing close to 3% at this latter date, the lowest level since October 2005. Financial and non-financial corporations' credit risk premia have also remained on the declining trend of the previous months (see Chart 1.1.C). Since late October, stock market indices in the advanced countries have risen while those in the emerging countries have dipped somewhat, on average, albeit showing a greater degree of heterogeneity (see Chart 1.1.D).

In the emerging countries, uncertainty came to depend on more idiosyncratic factors. Although there were global bouts of instability (such as that at the end of January referred to above), these were short-lived and their effect only persisted in specific countries.

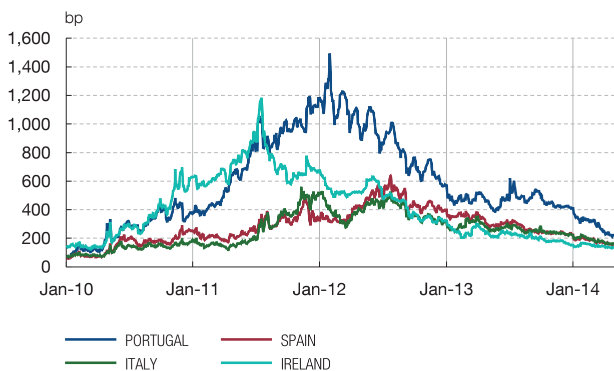
Global economic activity quickened in the second half of 2013 owing to the rebound in the advanced economies

In the second half of 2013, international economic activity quickened to a rate of around 3.5%, 1 pp up on the first half of the year, essentially as a result of the rebound in the advanced economies, which on average ended the year posting an annual increase of 2%. The latest data point to some easing in the growth of these economies in early 2014, owing to specific factors. That said, some strengthening is expected in the coming quarters, with a rate of

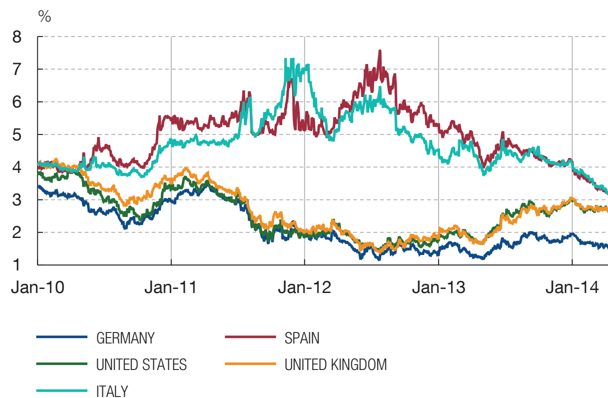
PRICES NEGOTIATED ON FINANCIAL MARKETS

CHART 1.1

A. TEN-YEAR GOVERNMENT BOND YIELDS: SPREAD OVER GERMANY



B. TEN-YEAR GOVERNMENT BOND YIELDS



C. FINANCIAL SECTOR CREDIT RISK INDICES (a)

D. STOCK EXCHANGE INDICES

SOURCES: Datastream, Reuters and Bloomberg.

a Euro area: 5-year iTraxx Europe Senior Financials. United States and United Kingdom: average 5-year CDS for commercial banks.
Latest data: 30 April 2014.

expansion that will increase by around 1 pp to approximately 2.3% in 2014-15, driven by softer fiscal adjustments (except in Japan), favourable monetary and financial conditions, the gradual pick-up in real estate and labour markets, and the increase in private-sector wealth.

By contrast, in the emerging economies the outlook has continued to worsen

In the second half of 2013 and in 2014 to date, the outlook has continued to worsen in the emerging economies. This was especially discernible in China, where the release of unfavourable figures adversely affected the commodities markets. Growth forecasts for 2014 have been revised downwards by around 0.5 pp for the aggregate of the emerging economies (EMEs), which even so are expected to show a slightly higher rate of increase than that in 2013.

The baseline scenario thus envisages a tendency of growth to stabilise in the EMEs at lower rates than the recent past, although the strengthening in the advanced economies may ultimately bear on their external demand and offset the gradual tightening of global financing conditions. That said, the balance of risks for these economies (especially those more reliant on external funding) has shifted to the downside in the current setting of turbulence, uncertainty and the contractionary reactions by certain central banks. Nonetheless, mention should be made of their greater resilience compared to the past, founded on the absorption capacity provided by the flexibility of exchange rates, sizeable buffers of international reserves, more developed fixed-income markets than in the past (which have

enabled currency mismatches and the average duration of debt to be reduced), more solvent banking systems and generally sounder macroeconomic policy frameworks. Moreover, the favourable stance towards reform in some of these economies and the relative strength of fundamentals has allowed for discrimination between them in the recent episodes. All these factors help soften the impact of the turbulence and restrict its transmission or spread.

Euro area GDP grew at a quarter-on-quarter rate of 0.2% in 2013 Q4, and the medium-term outlook is one of gradual recovery

In the last three months of 2013, euro area GDP posted a quarter-on-quarter increase of 0.2%, following 0.1% growth the previous quarter (see Chart 1.2.A). This rise is consistent with an outlook of slow and gradual recovery, with a balance of risks on the downside. In this setting, the ECB's March projection exercise forecasts growth of 1.2% for 2014, 1.5% for 2015 (in both cases the figures are very similar to those in the December exercise) and 1.8% for 2016 (the first occasion a projection has been made for this year).

In Spain, GDP grew by 0.2% and employment increased for the first time since early 2008. The short- and medium-term outlook is also one of gradual recovery

In the final quarter of 2013, GDP in Spain grew at a quarter-on-quarter rate of 0.2%, up from 0.1% in Q3. Reflecting this more favourable economic performance was an improvement in the labour market, where the first quarterly increase in employment (in seasonally adjusted terms) since early 2008 was recorded in the final stretch of the year. The unemployment rate tended to lower as from 2013 Q1, but it remains at a very high level, ending the year at 26% (see Chart 1.2.B). The information available for the opening months of 2014 suggests a prolongation of the moderately positive path of activity. Thus, according to the INE flash estimate, GDP grew at a quarter-on-quarter rate of 0.4% in 2014 Q1. Against this backdrop, the latest Banco de España projections point to GDP growth of 1.2% in 2014 and of 1.7% for 2015.[1]

The ongoing decline in household and corporate debt continues, and the latest data show some pick-up in household wealth and in corporate profitability...

Over the final months of 2013, the debt ratios of households and non-financial corporations continued falling, though they remain at higher levels than the related euro area averages. The proportion of income earmarked for payments associated with the debt of these sectors also fell. In the case of households, the latest information on wealth, relating to 2013 Q4, evidences a stabilisation, following the declines in recent years. The data available on corporate profits also show a more favourable trend. Specifically, the ordinary net profit of the corporations reporting to the Banco de España Central Balance Sheet Data Office Quarterly Survey (CBQ) grew by 2.3% in 2013, interrupting the negative path of the two previous years. This was mirrored in a slight rise in the return on investment in the CBQ sample.

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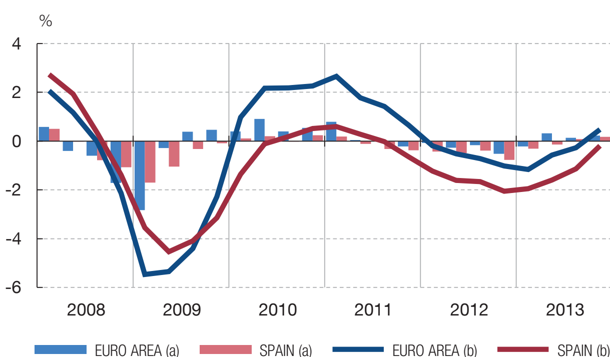
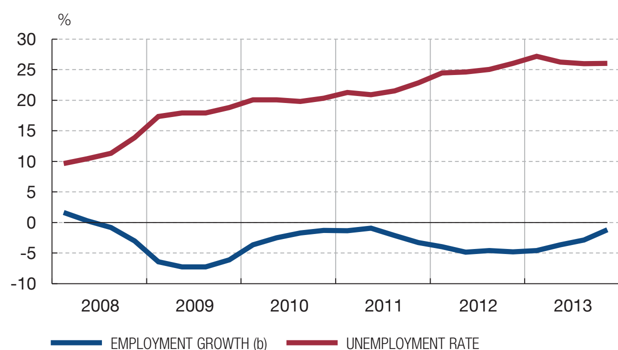
1 See the "Spanish economic projections report". *Economic Bulletin,* March 2014.

GDP AND EMPLOYMENT — **CHART 1.2**

A. YEAR-ON-YEAR AND QUARTER-ON-QUARTER GDP GROWTH



B. YEAR-ON-YEAR EMPLOYMENT GROWTH AND UNEMPLOYMENT RATE. EPA DATA



SOURCES: INE, Eurostat and Banco de España.

a Quarter-on-quarter rates.
b Year-on-year rates.

…while general government debt continues to burgeon

In the case of general government, the year-on-year rate of increase of debt stood in February at 8%, while the latest data on the debt ratio, relating to 2013 Q4, place it at 93.9% of GDP.

In sum, conditions on European financial markets continue to improve, although a high degree of fragmentation persists. The Spanish economy is growing at a moderate pace, and is forecast to continue doing so in the short and medium term

In sum, since the publication of the last FSR, the ongoing improvement in conditions on European wholesale financial markets has continued. That said, a high degree of financial fragmentation persists, meaning that financing costs in Spain remain relatively high given the current expansionary monetary policy stance. The latest data show a moderate pattern of economic growth in Spain and slight increases in employment. This trajectory of gradual recovery is forecast to continue in the short and medium term, although these projections are shrouded in considerable uncertainty.

2.1 Banking risks

2.1.1 CONSOLIDATED BALANCE SHEET OF DEPOSIT INSTITUTIONS

The consolidated balance sheet of deposit institutions decreased by 10.2% in 2013…

The consolidated balance sheet of Spanish deposit institutions, which includes their business in Spain and that of their subsidiaries and branches abroad, decreased in 2013 at a year-on-year rate of 10.2% (see Chart 2.1). Part of this balance sheet erosion resulted from the transfer of real estate assets to Sareb by Group 2 banks in February 2013.[1] However, the rates of change of the main balance sheet items would be very similar if the aforementioned Group 2 banks were excluded from analysis.

…as a result of the decline in business in Spain and, to a lesser extent, in business abroad

The behaviour of assets was shaped by events in business in Spain, which fell by 12.7% year-in-year in December, and by the decline, albeit smaller, in business abroad, where total assets in December were down by 3.6% with respect to the same month a year earlier. The fall in assets abroad was largely due to exchange rate movements. Thus the euro appreciated between December 2012 and December 2013 with respect to the main currencies in which Spanish institutions conduct their business abroad, such as the Brazilian real (20% appreciation of the euro), the Chilean peso (14%) and, to a lesser extent, the Mexican peso (5.4%), the US dollar (4.5%) and the pound sterling (2.6%).

The weight of business abroad has been growing in recent years

In December 2013 business abroad represented 30.4% in terms of the total assets of deposit institutions, compared with 28.4% a year earlier (see Chart 2.1.F). This percentage has been growing in recent years as a result of the larger decline or lower growth of business in Spain. In any event, the exposures abroad of Spanish institutions are generally executed through subsidiaries which enjoy financial autonomy in their activities in the host country and whose business consists mostly of local operations in the local currency, which are circumstances that must be taken into account when assessing the risks derived from those exposures (see Box 2.1).

Financing to the private sector decreased by 7.2%, although its relative weight in the balance sheet increased

Financing to the private sector (credit and fixed income) decreased by 7.2% year-on-year, although its relative weight in the balance sheet increased to 62.7% (see memorandum item in Table 2.1 and Chart 2.1.C). This decline in financing was due both to the decrease in fixed income securities and, more particularly, to the fall in credit (see Chart 2.1.A). As will be explained below, the downward path of credit was mainly caused by developments in business in Spain, in line with the performance of the Spanish economy in this period and the process of reduction of corporate and household debt, along with other one-off factors, such as asset transfers to Sareb by some banks.

Financing to general government posted a negative year-on-year rate of change of 3.9% in 2013

Financing to resident and non-resident general government (credit and fixed income) posted a negative year-on-year rate of change of 3.9% in December 2013, due particularly to the change in credit (–17.5%), while there was a moderate increase in government debt securities (2.7%). The decrease in financing to general government was apparent both in business in Spain, particularly in credit, and in business abroad (–3.8% and –4% year-on-year,

1 Groups 1 and 2 comprise those institutions which needed State aid to recapitalise, as agreed in the Memorandum of Understanding (MoU) for financial assistance to Spanish banks. Group 1 originally consisted of BFA/Bankia, Catalunya Caixa, Nova Caixa Galicia and Banco de Valencia, while Group 2 consisted of Cajatres, CEISS, Liberbank and Banco Mare Nostrum. The transfers by Group 1 banks to Sareb do not affect the December 2013 year-on-year rate of change because these transfers were already included in the information as at December 2012. The Group 2 banks transferred their assets in February 2013.

CONSOLIDATED BALANCE SHEET.
DEPOSIT INSTITUTIONS

TABLE 2.1

ASSETS	Dec-13	Change Dec-13/ Dec-12	Relative Weight Dec-12	Relative Weight Dec-13
	(€m)	(%)	(%)	(%)
Cash and balances with central banks	141,011	-22.9	4.7	4.1
Loans and advances to credit institutions	183,189	-22.4	6.1	5.3
General government	94,722	-17.5	3.0	2.7
Other private sectors	2,027,253	-7.4	56.6	58.4
Debt securities	562,452	-2.0	14.8	16.2
Other equity instruments	38,953	0.0	1.0	1.1
Investments	46,992	-12.8	1.4	1.4
Derivatives	163,863	-37.8	6.8	4.7
Tangible assets	50,672	7.1	1.2	1.5
Other (a)	163,754	-1.3	4.3	4.7
TOTAL ASSETS	**3,472,862**	**-10.2**	**100**	**100**
MEMORANDUM ITEMS				
Financing to private sector	2,178,643	-7.2	60.7	62.7
Financing to general government	439,405	-3.9	11.8	12.7
Total doubtful assets	222,858	14.1	5.1	6.4
Total doubtful assets ratio	7.8	149 (c)		
Provisions for bad debts and country risk	-124,867	-6.2	-3.4	-3.6

LIABILITIES AND EQUITY	Dec-13	Change Dec-13/ Dec-12	Relative Weight Dec-12	Relative Weight Dec-13
	(€m)	(%)	(%)	(%)
Balances from central banks	214,269	-43.5	9.8	6.2
Deposits from credit institutions	382,487	-9.5	10.9	11.0
General government	84,190	-11.1	2.4	2.4
Other private sectors	1,742,627	1.3	44.5	50.2
Marketable debt securities	402,378	-18.3	12.7	11.6
Derivatives	151,567	-37.9	6.3	4.4
Subordinated debt	42,947	-30.0	1.6	1.2
Provisions for pensions, tax and other	35,326	-2.2	0.9	1.0
Other (a)	184,996	-8.5	5.2	5.3
TOTAL LIABILITIES	**3,240,789**	**-11.3**	**94.4**	**93.3**
MEMORANDUM ITEMS				
Eurosystem net lending (b)	183,454		6.7	5.3
Minority interests	26,858	48.0	0.5	0.8
Valuation adjustments relating to total equity	-16,801	.	-0.3	-0.5
Own funds	222,017	6.3	5.4	6.4
TOTAL EQUITY	**232,074**	**7.9**	**5.6**	**6.7**
TOTAL LIABILITIES AND EQUITY	**3,472,863**	**-10.2**	**100**	**100**

SOURCE: Banco de España.

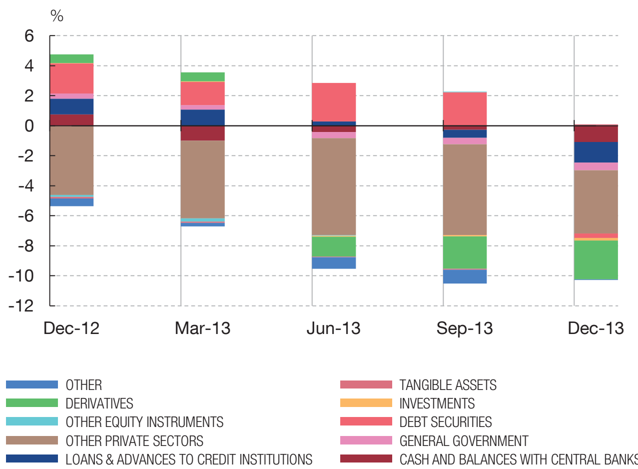
a The remaining assets and liabilities entries not explicitly considered, including valuation adjustments, are included in "Other".
b Difference between funds received in liquidity providing operations and funds delivered in absorbing operations. March 2014 data (latest available) and March 2013 data to maintain the year-on-year comparison.
c Difference calculated in bp.

respectively). In any event, in the total consolidated balance sheet, the drop in credit, whose relative weight in the balance sheet fell (2.7% in December 2013 against 3% a year earlier), did not offset the rise in fixed income securities. Hence the relative weight of total financing to general government (credit and fixed income) in the balance sheet rose to 12.7%, compared with 11.8% in December 2012 (see memorandum item of Table 2.1).

CONSOLIDATED BALANCE SHEET

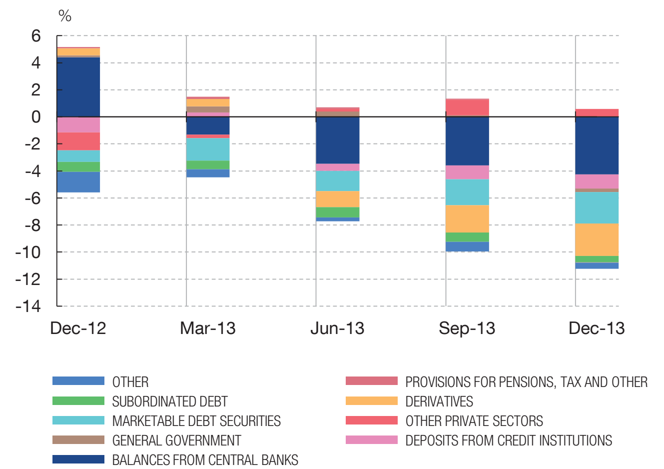
CHART 2.1

A. CONTRIBUTION TO THE CHANGE IN CONSOLIDATED TOTAL ASSETS



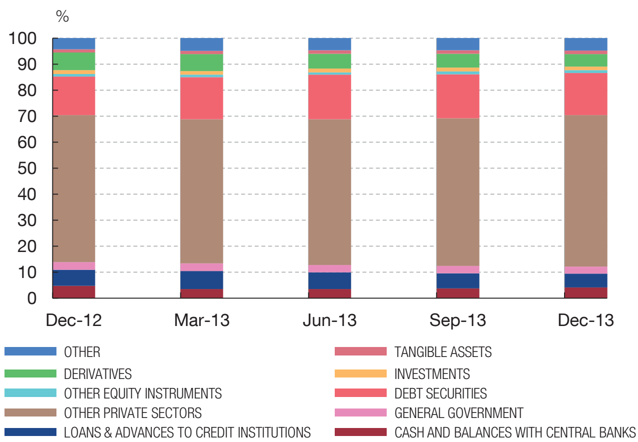
OTHER
DERIVATIVES
OTHER EQUITY INSTRUMENTS
OTHER PRIVATE SECTORS
LOANS & ADVANCES TO CREDIT INSTITUTIONS
TANGIBLE ASSETS
INVESTMENTS
DEBT SECURITIES
GENERAL GOVERNMENT
CASH AND BALANCES WITH CENTRAL BANKS

B. CONTRIBUTION TO THE CHANGE IN CONSOLIDATED TOTAL LIABILITIES



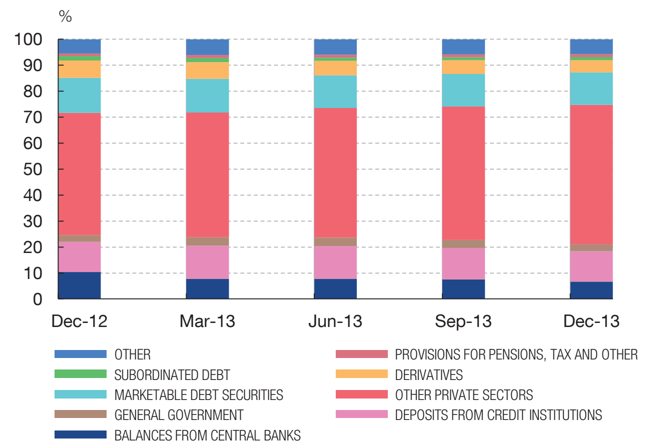
OTHER
SUBORDINATED DEBT
MARKETABLE DEBT SECURITIES
GENERAL GOVERNMENT
BALANCES FROM CENTRAL BANKS
PROVISIONS FOR PENSIONS, TAX AND OTHER
DERIVATIVES
OTHER PRIVATE SECTORS
DEPOSITS FROM CREDIT INSTITUTIONS

C. CONSOLIDATED ASSETS: RELATIVE WEIGHTS



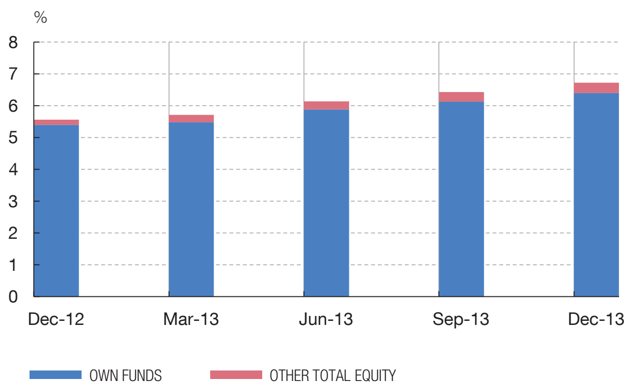
OTHER
DERIVATIVES
OTHER EQUITY INSTRUMENTS
OTHER PRIVATE SECTORS
LOANS & ADVANCES TO CREDIT INSTITUTIONS
TANGIBLE ASSETS
INVESTMENTS
DEBT SECURITIES
GENERAL GOVERNMENT
CASH AND BALANCES WITH CENTRAL BANKS

D. CONSOLIDATED LIABILITIES: RELATIVE WEIGHTS



OTHER
SUBORDINATED DEBT
MARKETABLE DEBT SECURITIES
GENERAL GOVERNMENT
BALANCES FROM CENTRAL BANKS
PROVISIONS FOR PENSIONS, TAX AND OTHER
DERIVATIVES
OTHER PRIVATE SECTORS
DEPOSITS FROM CREDIT INSTITUTIONS

E. TOTAL EQUITY OVER TOTAL ASSETS. CONSOLIDATED DATA



OWN FUNDS
OTHER TOTAL EQUITY

F. WEIGHT OF FOREIGN BUSINESS IN CONSOLIDATED TOTAL ASSETS

SOURCE: Banco de España.

THE INTERNATIONAL EXPOSURE OF SPANISH BANKS — BOX 2.1

Expectations about the withdrawal of monetary stimulus in the United States had a more marked impact than expected on emerging economies. This prompted a downward revision of their outlook for growth (which in any event remains, in most cases, higher than that of developed countries). In this setting, it may be informative to describe the type of external exposure of Spanish banks in order to interpret the risks posed and to show its geographical distribution in December 2013.

At consolidated level, a bank's financial assets[1] in a specific country include both financial assets resulting from the local activity undertaken by its subsidiaries in that country and financial assets arising from the non-local activity at the parent (strictly speaking cross-border activity) or at another subsidiary located in a third country. Both types of assets may be denominated in the currency of the country in question or in any other currency. The prevalence of one group of assets over another (cross-border compared with the assets of subsidiaries abroad) gives an accurate idea of the business model developed by the bank for its international activity.

74% of financial assets abroad relate to local activity and, more specifically, 69% relate to local activity denominated in local currency.[2] This concentration points to a decentralised international business model in which Spanish banks operate abroad through independently financed local subsidiaries. Additionally, these banks are retail in nature and are mostly financed by local deposits in local currency, which make up a very large portion of their liabilities. The subsidiary-based structure leads them to having to comply with the same rules as other domestic banks with the same requirements in relation to capital, liquidity, governance structure and resolution plans. This local presence in the countries where Spanish banks operate affords them a better ability to react to adverse events occurring in those countries and a comparative advantage in terms of risk compared with banks which base their international exposure on cross-border investments. On one hand, the knowledge and proximity obtained through subsidiaries reduces credit risk not only in the local market but also in cross-border transactions. On the other, domestic funding of local operations decreases the exchange rate risk and also the liquidity risk insofar as a bank can be frozen out of international markets more easily than local markets (especially if it is a relatively large bank locally but a relatively small one internationally).

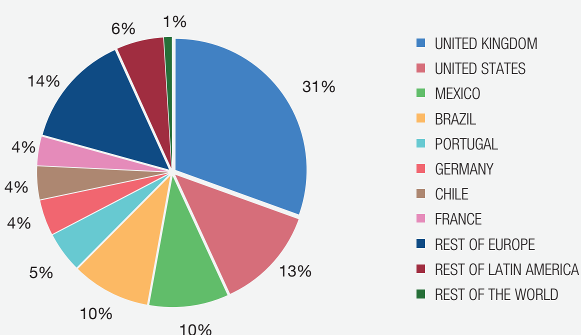
In quantitative terms, the volume of Spanish banks' financial assets abroad, as a whole, represents 38% of their total volume of financial assets. Most of this international activity (around 90%) relates to the two largest banks in Spain's banking system, whereas the volume of other banks is very small. As for geographical distribution, their activity is centred on Europe and America, while the rest of the world scarcely represents 1% of international activity (see Panel A). The United Kingdom accounts for nearly one third of financial assets abroad, followed by the United States with 13% and Mexico and Brazil, which represent 10% each. 27% of assets abroad are located in the rest of Europe, most notably in Portugal, Germany and France, while practically all of the remaining activity relates to Latin America.

A comparison of the quality of these financial assets abroad must take into account that the areas have different characteristics in terms of profitability, competition and their position in the economic cycle. Thus, the NPL ratio currently stands at lower levels than those seen in Spain (see Panel B). In emerging countries with a larger presence of Spanish banks (Mexico, Brazil and Chile) the ratio is between 4.3% and 2.3%. It is lower in the United States and the main European countries and stands only slightly higher in Portugal at just above 6%. This lower NPL ratio is because the economies where Spanish banks operate are at different points in the cycle and this is testament to the fact that geographical diversification has contributed to lowering the aggregate risk of the Spanish banking system.

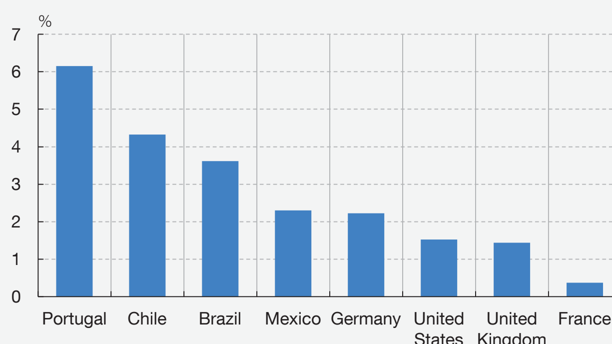
1 Financial assets include the total volume of loans (including those to other institutions and the public sector), fixed-income securities, derivatives and other types of financial assets recorded in Spanish banks' balance sheets.

2 The small difference between the two percentages which shows local activity in non-local currency mainly refers to the activity in euro in countries which are not part of the euro area such as Poland, Turkey or Sweden and countries where there is significant dollarisation.

A. GEOGRAPHICAL BREAKDOWN OF FINANCIAL ASSETS ABROAD
Deposit institutions. December 2013



B. NPL RATIO OF FINANCIAL ASSETS ABROAD
Deposit institutions. December 2013



SOURCE: Banco de España.

Total NPLs continued growing due to business in Spain

Total NPLs at consolidated level continued growing in 2013. The year-on-year rate of change was 14.1% in December. This increase in NPLs was due exclusively to business conducted in Spain (year-on-year change of 16.9%), while total business abroad showed a decrease of 5.2% in NPLs. The deterioration in credit quality was also perceived in the total NPL ratio at consolidated level,[2] which grew to 7.8% in December 2013 (against 6.3% in December 2012). It was business in Spain which caused the rise in this ratio (9.8% in December 2013, up 2.3 pp), while in business abroad the ratio fell slightly from 3% in December 2012 to 2.9% a year later. The rise in the NPL ratio in business in Spain is analysed in more detail below.

In December 2013 the increase in total NPLs at consolidated level (14.1%) was compatible with a slowdown in the year-on-year rate of change of loan loss and country risk provisions (–6.2%). The reasons for this, albeit with a certain heterogeneity among institutions, were mainly: charge-offs; additions to mortgage NPLs from the retail portfolio as a result of review of refinancing and restructuring transactions, in which, because of their nature, the provisions are on average lower than in the rest of the portfolio; and, finally, reclassifications to NPLs from the property development portfolio to which the general provisions recorded under the 2012 royal decree-laws were reassigned.

Derivatives decreased significantly on both the assets and liabilities sides (37.8% on the assets side and 37.9% on the liabilities side), such that the net position changed little. This is largely explained by the calculation of interest rate derivatives and by the extension of position netting agreements.

On the assets side, financing to the private sector gained weight relative to deposits with central banks, deposits with credit institutions and derivatives operations

In short, at the consolidated balance sheet level, on the assets side the decline in financing to the private sector persisted, although this was compatible with a certain shift in the asset mix away from deposits with central banks, loans and advances to credit institutions and derivatives operations towards a higher relative weight of financing to the private sector and, to a lesser degree, to the public sector (see Chart 2.1.C).

There was a shift in the liabilities mix towards private sector deposits

On the liabilities side (see Table 2.1) there was a reshuffling of some items, with private sector deposits gaining relative weight (see Chart 2.1.D). Deposits from central banks decreased by 43.5% and their relative weight in the balance sheet dropped from 9.8% in December 2012 to 6.2% in December 2013. Deposits from central banks had increased notably in 2012 (see Chart 2.1.B) due to operations with the Eurosystem, which provided long-term liquidity to allay euro area financial market tensions and, in particular, to counter money market malfunction. Net recourse to the Eurosystem (difference between funds received and deposited) by Spanish institutions reached its peak in August 2012, when this funding accounted for 9.7% of total assets. Since then its significance has declined considerably month by month. By December 2012 it had fallen to 8.1% and a year later, in December 2013, to 5.8%. The latest available figure, for March 2014, shows that the downward trend continues (5.3%, see memorandum item of Table 2.1).

Deposits from credit institutions decreased...

Deposits from credit institutions fell by 9.5% year-on-year in December 2013, although their weight relative to total assets remained at 11%. This decrease is much smaller than that in the asset position (22.4%), where credit to deposit institutions lost relative weight in assets, falling from 6.1% to 5.3%.

2 In addition to credit to the resident private sector, this figure includes that to general government and to credit institutions.

...while deposits from the private sector grew

Private sector deposits on the consolidated balance sheet grew by 1.3% in December 2013 with respect to the same month of the previous year, particularly in business in Spain, so as to rise from 44.5% to 50.2% of assets. Notably, this is the only liability item in Table 2.1 with a positive year-on-year rate of change in December 2013. This change, along with that of financing to the private sector, gave rise to an improvement in the retail funding gap at consolidated level.

Marketable securities posted negative rates of change

Although financial market conditions improved somewhat, prompting some securities issuance in the wholesale markets, marketable securities continued to show negative rates of change (–18.3% in December 2013 with respect to the same period of the previous year), which made for a certain loss of relative weight in the balance sheet (down from 12.7% to 11.6% in December 2013). Subordinated debt also showed a downward trend, exacerbated by burden-sharing exercises carried out by Group 1 and 2 banks. In any event, leaving conjunctural factors to one side, there seems to be a certain structural shift in the liabilities mix towards deposits and away from wholesale funding.

Equity increased, due partly to the recapitalisation of Group 1 and 2 banks

The total equity of deposit institutions increased at a year-on-year rate of 7.9% in 2013. This increase in equity was partly due to the recapitalisation of Group 1 and 2 banks. Excluding these banks, equity grew by 0.3%, which made for an increase from 6.4% to 7.1% in terms of assets. Equity went from representing 5.6% of total assets in December 2012 to 6.7% a year later (see Chart 2.1.E), with own funds increasing by 1 pp, from 5.4% to 6.4% in terms of assets. This change, together with that of private sector deposits, manifests the shift in the balance sheet mix under way in the Spanish banking sector.

In short, the consolidated balance sheet of Spanish banks reflects a certain structural change: on the assets side, the relative weight of lending to the private sector has increased, while on the liabilities side the relative weight of deposits has risen. This change in balance sheet structure demonstrates the capacity of Spanish banks to adapt to the highly complex environment in which they still operate.

2.1.2 CREDIT TO AND NPLS OF THE RESIDENT PRIVATE SECTOR IN BUSINESS IN SPAIN (ID)

Credit decreased by 8.2% in February in year-on-year terms

Credit to the resident private sector in business in Spain, as per individual financial statement data (see Chart 2.2.A), decreased by 8.2% year-on-year in February 2014 for deposit institutions as a whole (latest figures available to date).[3] After total credit is adjusted for the effect of transfers from Group 1 and 2 banks, which affects the calculation of year-on-year rates of change from December 2012 to January 2014, inclusive, it can be seen (see Chart 2.2.A) that the downward trend in credit tended to steady from mid-2013, holding thereafter at negative year-on-year rates of around 8%.

Sectoral analysis shows that credit to individuals, particularly for purposes other than house purchase, decreased

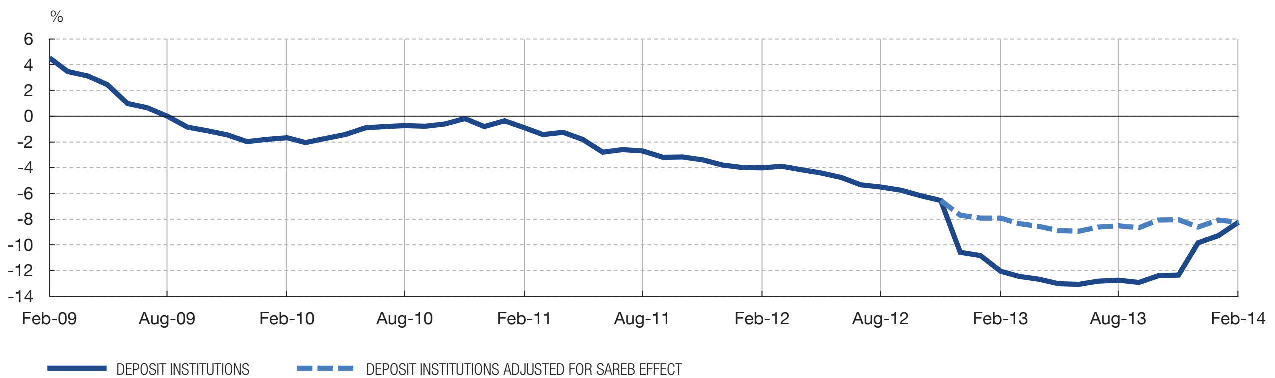
The December 2013 data (the latest available) enables credit to be analysed by institutional sector and by industry. Credit to individuals decreased by 5.4% year-on-year in December 2013 for deposit institutions as a whole, compared with a decrease of 4.9% in the same month of the previous year. The decline was more marked in credit granted for purposes other than house purchase (–10.3%) than in that granted for house purchase (–4.6%), although the former showed a slight slowdown in its fall with respect to the previous year (–11.9% in December 2012) while the pace of fall of the latter quickened by 1 pp (–3.6% a year earlier; see Chart 2.2.B).

3 From January 2014 establecimientos financieros de crédito are no longer classified as credit institutions, so the translation of this term into English as “specialised credit institutions” has been changed to “credit financial intermediaries”. This reclassification means that credit granted to these entities is now considered to be credit to the resident private sector. To enable these time series to be compared over time, the pertinent adjustments have been made to neutralise the change.

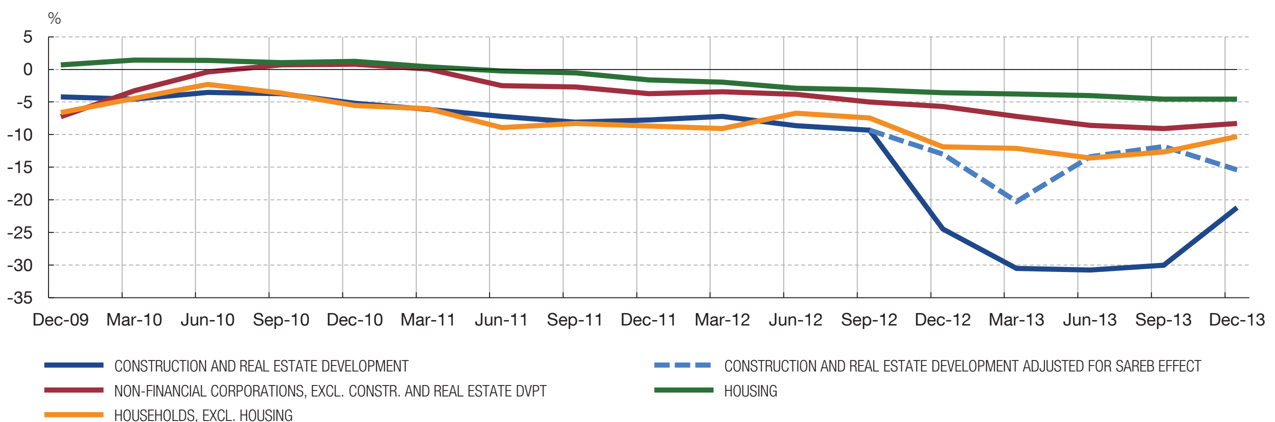
CREDIT TO THE RESIDENT PRIVATE SECTOR
Business in Spain, ID. Deposit institutions

CHART 2.2

A. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR



B. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR BY SECTOR OF ACTIVITY



SOURCE: Banco de España.

Credit to non-financial corporations decreased by 13.7% under the downward influence of the transfers to Sareb

Credit to non-financial corporations in December 2013 was down by 13.7% year-on-year. The transfers to Sareb by Group 1 and 2 banks in December 2012 and February 2013, respectively, were linked to construction and real-estate development firms. Taking into account the impact of the transfer to Sareb by Group 2 banks and making the related adjustment, the decrease for non-financial corporations as a whole was smaller, at 11.2%.

The year-on-year rate of change of credit to non-financial corporations in construction and real-estate development in December 2013 was –21.2%. Adjusted for the effect of transfers to Sareb, the fall decreases to 15.4%, slightly larger than that in December 2012 (–13%). Chart 2.2.B shows these year-on-year rates of change for the last few quarters after adjustment for the impact of these transfers.

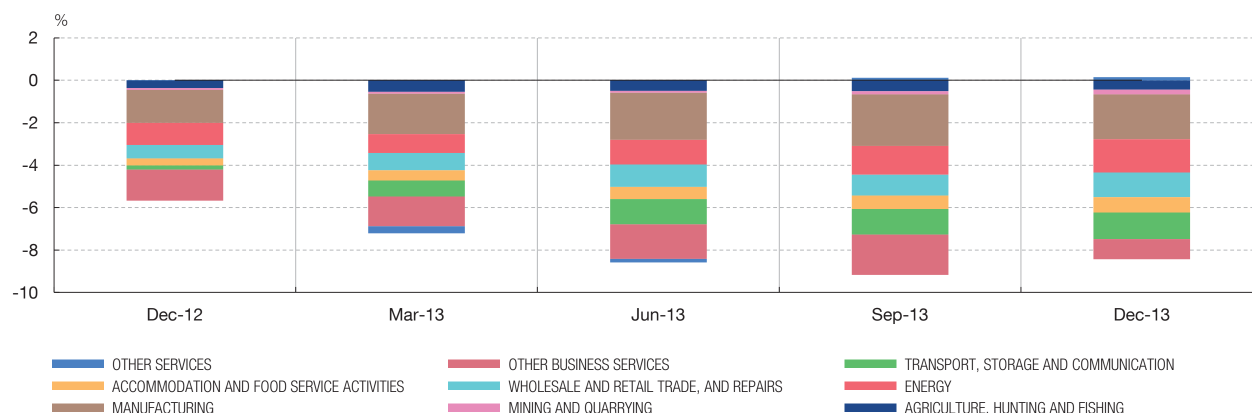
The decrease in credit was broad based across industries...

Credit to non-financial corporations other than those in construction and real-estate development moved downward in 2013 (–8.3% year-on-year), although the fall tended to moderate somewhat in the last few months of the year. The industries which most contributed to accelerating the fall in credit to non-financial corporations other than those in construction and real-estate development in the past year were transport, storage and communication (–12.8% year-on-year), manufacturing (–10.4%) and trade and repairs (–6.4%). Meanwhile, other business services (–5.5%) and other services (growth of 1.4%) showed a certain recovery in their rates of change with respect to the previous year (see Chart 2.3).

CREDIT TO THE RESIDENT PRIVATE SECTOR
Business in Spain, ID. Deposit institutions

CHART 2.3

A. CONTRIBUTIONS TO THE YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR OF SECTORS OF ACTIVITY EXCLUDING CONSTRUCTION AND REAL ESTATE DEVELOPMENT



SOURCE: Banco de España.

... and across firm size classes

The relatively widespread decrease in credit was also apparent across the various sizes classes of non-financial corporations. Central Credit Register (CCR) data can be used to approximate the size of non-financial corporations through their volume of bank debt reported to the CCR. Distinguishing the non-financial corporations other than those in construction and real-estate development by size, and on the basis of this approximation, a clear dichotomy is apparent between the behaviour of bank credit to larger firms and to other firms. For other firms the rates of fall are more moderate and, although rather volatile, a trend towards deceleration of the fall in credit is discernible (see Chart 2.4.A). As noted in previous quarters, the larger non-financial corporations, at a time of improving financial market conditions, issued debt securities, which, together with the deleveraging of their balance sheets, contributed to explaining the trend in the bank credit received by them (see Chart 2.4.B).

The new credit granted between two periods can be approximated using the information sent by institutions to the Banco de España in accordance with European Central Bank Regulation 63/2002 and with the related Banco de España circulars. The new credit variable envisaged in these statistics is credit granted for the first time to customers plus any credit agreements from previous periods whose amount, interest rate or other financial conditions substantially affecting interest rates may have been renegotiated with the customer in the month.

New credit fell more slowly

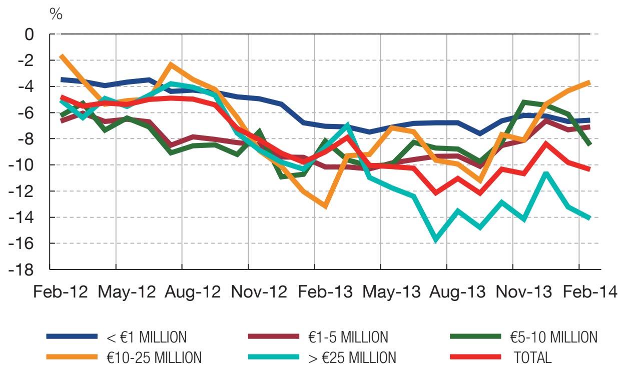
Taking into account these considerations, it can be seen that new credit[4] to non-financial corporations in 2013 also showed negative rates of change in 2013 compared with the previous year (–11% in December). However, this year-on-year fall was smaller than in previous months, when it reached rates of –28% in June (see Chart 2.4.C). Loans of less than €1 million to non-financial corporations (associated mainly with SMEs) showed a more notable recovery in their rates of change, which even turned positive in December 2013 (1%). The change of trend in credit extension encompassed all loan sizes from 2013 Q3. The latest available data, relating to February, reflect behaviour in this same line, with new credit below €1 million showing a year-on-year rate of change of 4.8% (see Chart 2.4.C).

4 The data on amounts have been constructed as the moving average of the month in question and of the last five months in order to reduce the volatility of the monthly time series. Rates of change are calculated from these series.

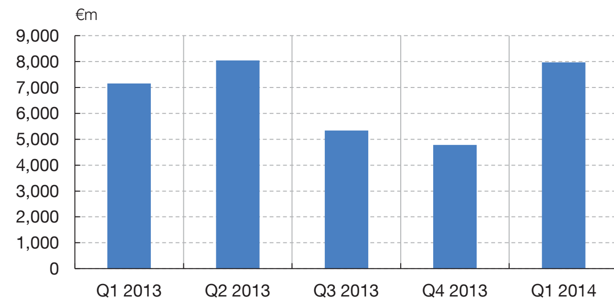
CREDIT TO THE RESIDENT PRIVATE SECTOR
Business in Spain, ID. Deposit institutions

CHART 2.4

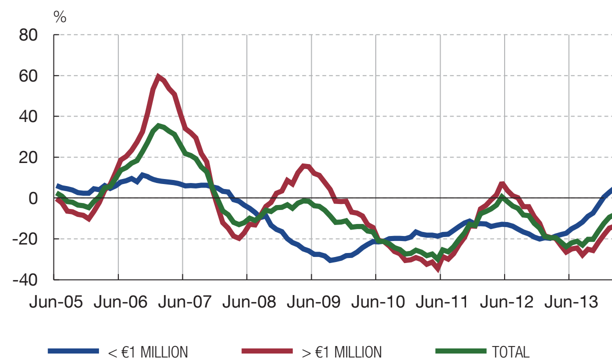
A. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO NON-FINANCIAL CORPORATIONS, EXCLUDING CONSTRUCTION AND REAL ESTATE DEVELOPMENT, BY SIZE OF CORPORATION (a)



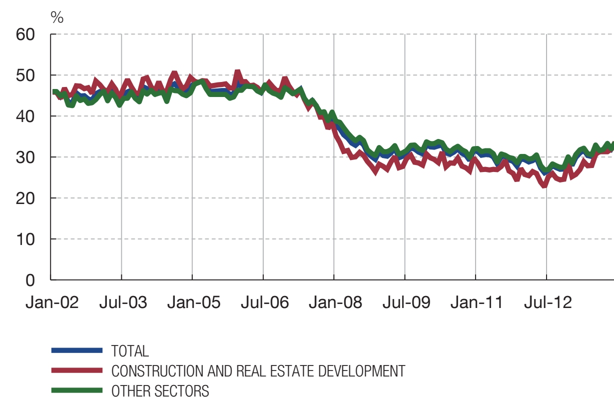
B. MAIN ISSUES OF SPANISH INSTITUTIONS IN MEDIUM- AND LONG-TERM WHOLESALE MARKETS



C. YEAR-ON-YEAR RATE OF CHANGE IN NEW CREDIT TO NON-FINANCIAL CORPORATIONS (b)



D. ACCEPTANCE RATES FOR CREDIT APPLICATIONS OF NON-FINANCIAL FIRMS (c)



SOURCES: Dealogic, Central Credit Register (CCR) and Banco de España.

a Corporation size is proxied by the volume of bank debt reported to the Banco de España Central Credit Register.
b New loans include loan arrangements for the first time as well as previous contracts whose amount, interest rate or other interest rate-related substantial financial conditions were renegotiated in the month with the clients. To reduce the volatility of the monthly series, data are constructed as the moving average of the last six months. The rate of change is calculated based on these series.
c Non-financial firms which apply for a loan to an institution with which they are not working or have not maintained a credit relationship in the last three months. The acceptance rate is defined as the ratio between the transactions accepted by deposit institutions and the total applications received in a particular month.

There was an upward trend in the rate of acceptance of loan applications made by non-financial corporations to deposit institutions with which they are not working

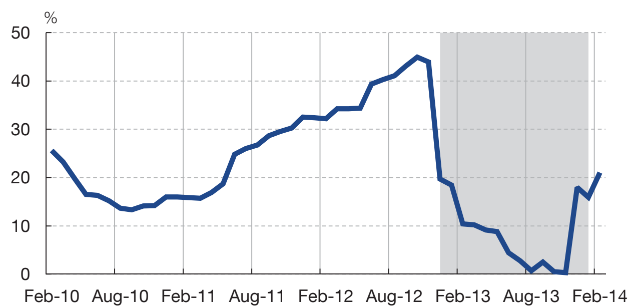
CCR data can be used to calculate the acceptance rates of loan applications made by non-financial corporations to deposit institutions with which they are not working or with which they have not had a credit relationship in the preceding few months.[5] In line with the credit behaviour described above, these acceptance rates have shown an upward trend in recent months, rising to around 34% at end-2013 compared with levels around 30% at end-2012 (see Chart 2.4.D). The acceptance rates since the outset of the crisis are slightly lower for construction and real estate development firms than for other non-financial firms. The change of trend in acceptance rates is clearer, and the levels higher, if institutions recapitalised with public funds are excluded.

5 For the subset of firms referred to, the rate of acceptance is defined as the loans accepted by deposit institutions divided by the total applications received in a given month. This analysis should be interpreted with due caution, first because of the small sample of firms, and second because changes in the rates of acceptance may have various causes ranging from alterations in demand to variations in conditions offered by banks.

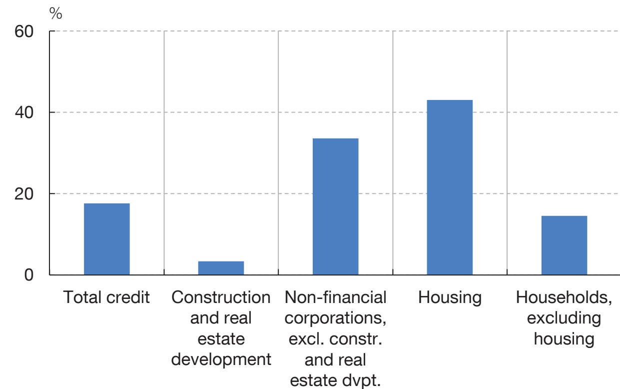
DOUBTFUL ASSETS. RESIDENT PRIVATE SECTOR.
Business in Spain, ID. Deposit institutions

CHART 2.5

A. YEAR-ON-YEAR RATE OF CHANGE IN NPLs (a)



B. YEAR-ON-YEAR RATE OF CHANGE IN NPLs BY SECTOR OF ACTIVITY. DECEMBER 2013



SOURCE: Banco de España.

a Between December 2012 and January 2014, including both dates (shaded zone iin the graph), annual rates of change were affected by transfers to Sareb by Group 1 institutions (in December 2012) and by Group 2 institutions (in February 2013).

In short, the latest available data show that credit at the aggregate level is still decreasing and that the fall is relatively broad based across institutional sectors and industries. The pace of this general downward trend moderated and has held steady since mid-2013. Differences still persist in the sharpness of that fall across borrowers, perceptible for example across industries.

The fall in credit reflects the economic situation, the necessary adjustment of agents' excessive indebtedness and the still-high fragmentation of the euro area

The fall in credit, which has moderated in recent months, reflects the economic situation, the necessary adjustment of agents' excessive indebtedness and the still-high fragmentation of the euro area. Box 2.2 sets out the situation of refinanced and/or restructured loans in the Spanish banking sector, which constitute a still-significant part of the credit portfolio of Spanish deposit institutions and on which supervisory attention has particularly focused in the past year.

NPLs grew by 21.1% in February 2014

The **NPLs to the resident private sector (business in Spain)** grew by 21.1% in February 2014 (latest figure available to date) in year-on-year terms (see Chart 2.5.A). If the Group 1 and 2 banks are excluded from analysis so as to isolate the behaviour of NPLs from the effects of transfers to Sareb, the year-on-year rate of change in February 2014 is 25.6%, compared with 20.1% a year earlier.

NPLs grew both in non-financial corporations...

Sector/industry analysis based on data as at December 2013 (the latest available for this sectorisation) shows differences in the rate of increase of NPLs to non-financial corporations (13.1% year-on-year) and to individuals (34.6% year-on-year). However, excluding from non-financial corporations those engaging in construction and real estate development, a sub-sector subject to asset transfers to Sareb, the rate of increase of NPLs becomes more similar, amounting for non-financial corporations other than those engaging in construction and real estate development to 33.5% year-on-year in December 2013 (compared with the aforementioned 34.6% for individuals).

...and in households...

Within NPLs to individuals, behaviour differed between those linked to house purchase, which increased by 43% year-on-year in December 2013, reflecting the economic situation and, in part, the review of refinanced loans, and those linked to credit for other purposes, which increased by 15.8% (see Chart 2.5.B).

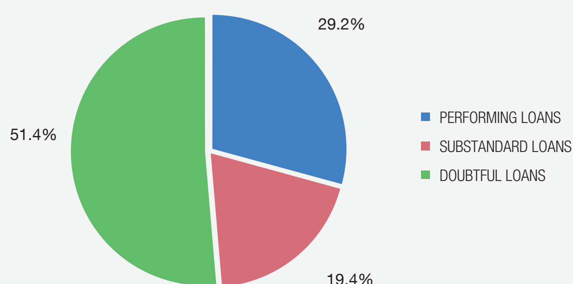
In order to increase transparency with regard to the quality of Spanish bank loans, the Banco de España took several measures under the Memorandum of Understanding signed by Spanish and European authorities in July 2012 with a view to improving the information available about the situation of refinanced and rescheduled operations in bank portfolios. First, Banco de España Circular 6/2012 of 28 September 2012 defines both types of operation and compels the banks to report their amount; classification as performing, sub-standard or doubtful; purpose and the related provisions. Second, on 30 April 2013 the banks were sent a letter with criteria about this type of operations encouraging them to review the classification for accounting purposes of their refinanced and rescheduled portfolios. Currently, Banco de España inspection teams are finalising the review of the application of the above-mentioned reclassification criteria for refinanced and restructured loans.

The data available as of December 2013 show, at the level of individual financial statements, that the volume of these operations in the credit portfolio of Spanish deposit-taking institutions, as a whole, stood at €211,273 million, 15.3% of lending to the private sector. Around half of the operations (51.4%) are classified under doubtful, whereas 29.2% are included under performing and 19.4% under sub-standard (see Panel A). Compared with the situation in December 2012, there has been a significant transfer (13 pp) from the performing to the doubtful category, while those classified as sub-standard remained relatively stable. The main reason for this change lies in the banks applying the reclassification criteria communicated to them by the Banco de España.

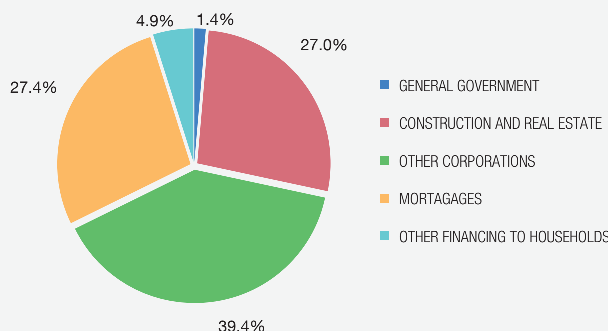
As for the sectoral distribution of refinanced and rescheduled operations, two-thirds relate to corporate lending (66.4%), slightly less than the remaining one-third relates to lending to households (32.3%) and, finally, 1.4% of the total are loans to general government. As for corporate lending, refinancing and rescheduling operations involving construction and real estate development firms represent 27% of the total refinanced lending whereas the financing of other firms accounts for 39.4% of said total (see Panel B). As for loans to households, mortgages, which are considered operations with individuals with a loan-to-value (LTV) of less than 100%, represent 27.4% of total refinanced lending, while other financing of households accounts for 4.9% of this total.

Finally, considering the weight of refinanced and rescheduled operations in total lending to each sector, the highest share is 38.5% (see Panel C) in the construction and real estate development industry. The relative share of refinanced and rescheduled operations in financing to households and corporations is limited to between approximately 7.5% and 15%, and in financing to general government it amounts to less than 4%.

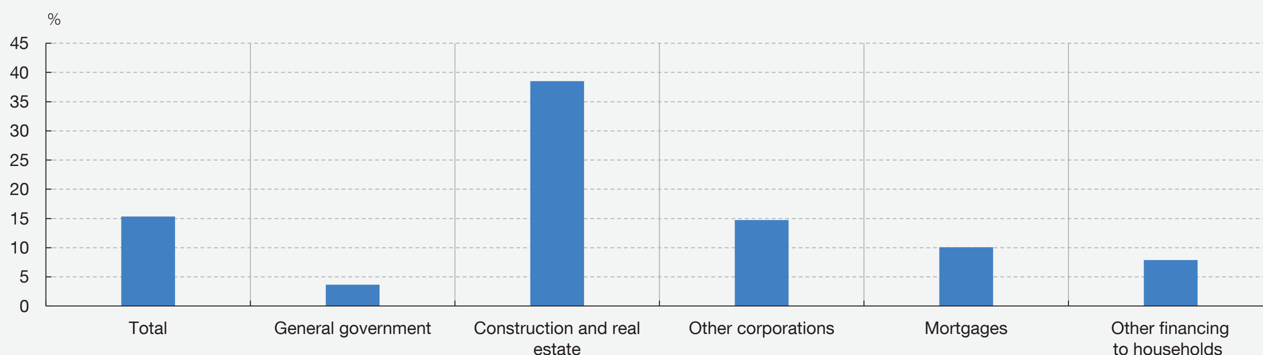
A. CLASSIFICATION OF REFINANCED AND RESTRUCTURED LOANS
December 2013



B. SECTORAL BREAKDOWN OF REFINANCED AND RESTRUCTURED LOANS
December 2013



C. WEIGHT OF REFINANCED AND RESTRUCTURED LOANS IN RESPECTIVE PORTFOLIOS
December 2013

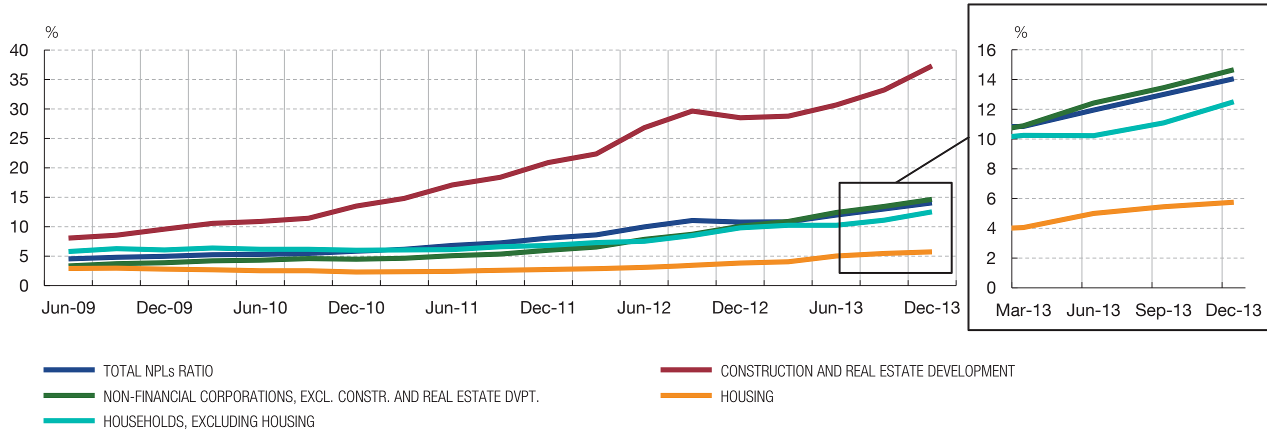


SOURCE: Banco de España.

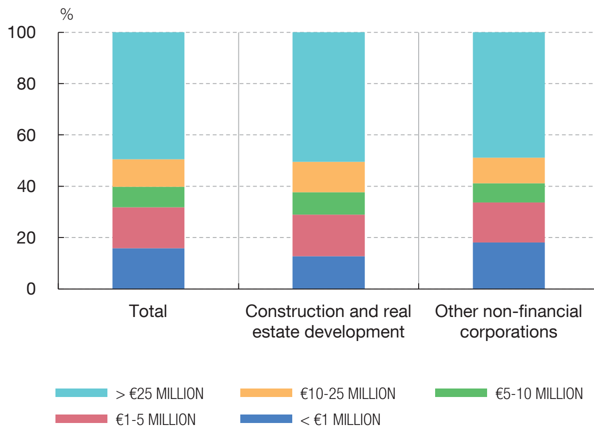
NPLs RATIOS FOR CREDIT TO THE RESIDENT PRIVATE SECTOR
Business in Spain, ID. Deposit institutions

CHART 2.6

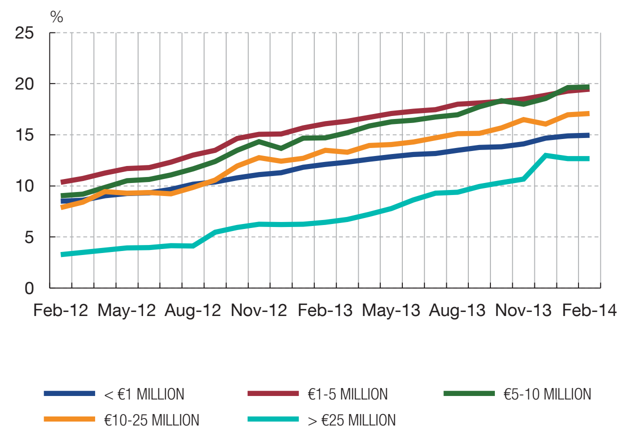
A. NPLs RATIO, BY SECTOR OF ACTIVITY



B. CREDIT TO NON-FINANCIAL FIRMS: WEIGHTS (a)
FEBRUARY 2014



C. NPLs RATIO OF NON-FINANCIAL FIRMS, EXCLUDING CONSTRUCTION AND REAL ESTATE DEVELOPMENT, BY SIZE OF CORPORATION (a)



SOURCES: Central Credit Register (CCR) and Banco de España.

a Corporation size is proxied by the volume of bank debt reported to the Banco de España Central Credit Register.

... resulting in an increase in NPLs in the resident private sector in Spain

The upward trend of NPLs and the ongoing decrease in credit resulted in an increase in the **NPL ratio** of the resident private sector in Spain to 14.1% in February 2014 (latest figure available), up 3.4 pp on the same month a year earlier.[6] The NPL ratio increase was broad based across institutions and industries.

This increase was broad based across sectors of activity...

Distinguishing by sector of activity, and on the data up to December 2013 (the latest available), the increase in the NPL ratio is seen to be across the board (see Chart 2.6.A). It grew by 2 pp in credit to individuals (6.7% in December 2013), both in that for purposes other than house purchase (up 2.9 pp to 12.7%) and in that for house purchase, which showed an upward trend shared by the various portfolio segments, albeit with appreciably more contained levels (up 1.9 pp on 2012 to 5.8%).

As regards non-financial corporations, the NPL ratio was 23.4% in December 2013, up 5.6 pp on the same month a year earlier. Particularly noteworthy here was the increase in the

6 As noted above, from January 2014 establecimientos financieros de crédito are deemed to form part of the resident private sector, so the NPL ratio time series has been adjusted to enable inter-period comparison.

NPL ratio of credit for construction and real estate development from 28.5% in December 2012 to 37.3% in December 2013. This ratio was lowered in December 2012 by the asset transfer to Sareb by Group 1 banks, and in December 2013 by the transfer by Group 2 banks. The NPL ratio for other non-financial corporations also trended upward, rising from 10% in December 2012 to 14.6% in December 2013, although, as indicated above, this increase was less marked than in construction and real estate development.

...and when non-financial corporations other than construction and real estate development firms are divided by size class based on the volume of their bank debt per the CCR

The relatively widespread upward trend of NPL ratios is also appreciated when non-financial corporations other than construction and real estate development firms are divided by size class, as approximated by their volume of bank debt reported to the CCR as per data to January 2014 (the latest available). This upward trend of NPLs shared by the various size classes is compatible with certain differences among them. Thus firms with bank debt above €25 million, which account for 49.5% of credit (see Chart 2.6.B), have a lower NPL ratio (12.7%). Although the NPL ratio of these larger firms has been converging with those of the rest, differences still persist, since for the other sizes analysed this ratio stood between 15% and 20% (see Chart 2.6.C) in January 2014.

In short, the NPLs of the resident private sector in Spain continued to rise throughout 2013. This increase was relatively widespread across borrowers and industries. Both the increase in the volume of NPLs, which is the numerator of the ratio, and the ongoing decrease in credit, the denominator, explain the upward trend in the NPL ratio which, in the current economic setting, will foreseeably persist in the coming months. Apart from the one-off factors which have pushed NPLs up, such as the review of refinanced loans requested of institutions by the Banco de España, the available empirical studies show that the NPL ratio is a lagged variable with respect to economic growth.

Foreclosed assets decreased, mainly due to asset transfers to Sareb by Group 2 banks

In December 2013 the foreclosed assets (those whose ownership passes to banks as a result of debt enforcement proceedings) of business in Spain decreased by 7.2% year-on-year, although this figure was strongly affected by the transfers to Sareb of certain real estate assets of Group 2 banks in February 2013. Including the amount of this transfer, foreclosed assets grew by 1.4% year-on-year.

2.1.3 FUNDING OF THE BANKING SECTOR

In recent months the improvement in the Spanish stock market has continued …

In the last few months of 2013 and early 2014 the Spanish stock market continued to improve, as reflected in the gains posted by the Ibex 35. Likewise, the ten-year Spanish government bond spread over the German benchmark continued to decline from its summer 2012 high (see Chart 2.7.A), while the yield on Spanish public debt stood at the end of April close to 3%. In 2013 the Ibex 35 rose more than 20%, while the risk premium fell by almost 200 basis points, or 44%.

… as has the decline in the level of systemic risk, which has remained low, as a consequence of the increase in confidence and the improvement in investor's perceptions

These improvements in the financial markets are reflected in the decline in the **level of systemic risk** in Spain, and in its stability at low levels in the latter months of 2013 and the first few months of 2014 (see Chart 2.7.B). The level of systemic risk in Spain has declined progressively from the highs of July and August 2012, and since October 2013 has remained at low levels close to those recorded before the financial crisis. This decrease has been seen in all the markets whose information is included in the systemic risk indicator: government debt, money, securities and bank funding markets. The progressive reduction in levels of tension and their holding at low levels in recent months in these markets may be explained by the increase in confidence and the improvement in the perception of investors in Spain's economic and financial situation, as well as by the decline in volatility on such markets.

FINANCIAL AND RISK INDICATORS (a) — CHART 2.7

A. IBEX35 AND RISK PREMIUM

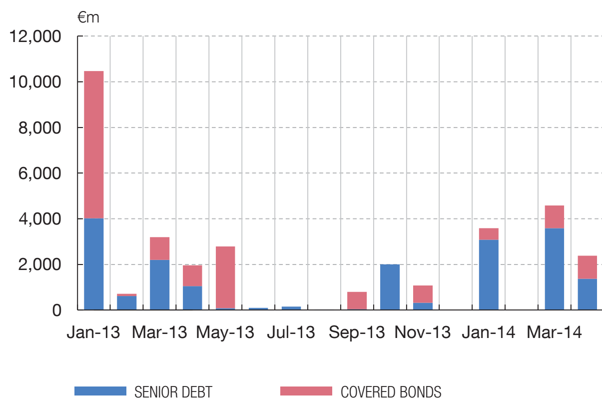
B. SYSTEMIC RISK INDICATOR (SRI) (b)

SOURCES: Datastream, ECB and Banco de España.

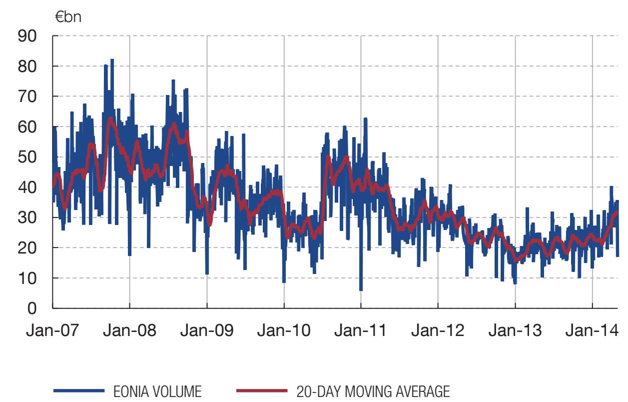
a Latest data: 30 April 2014.
b For a detailed explanation on this indicator, see Box 1.1 from FSR May 2013.

WHOLESALE FUNDING (a) — CHART 2.8

A. MAIN ISSUES OF SPANISH INSTITUTIONS IN MEDIUM- AND LONG-TERM WHOLESALE MARKETS (b)



B. EONIA TRADING VOLUME



C. OUTSTANDING AMOUNT PROVIDED THROUGH EUROSYSTEM TENDERS

SOURCES: Bloomberg, Dealogic and Banco de España.

a Latest data: 30 April 2014.
b Senior debt and covered bond issues are included. Retained issues are not included.

Despite this improvement in the conditions on the financial markets, the issuance activity of Spanish banks has not increased significantly to date

Although the conditions on the financial markets at the end of 2013 and the beginning of 2014 have continued to display some improvement and stability, as in the preceding months, Spanish banks as a whole have not significantly increased their **issuance activity** (see Chart 2.8.A). The objective of some Spanish banks to reduce their wholesale funding, and thus increase the relative weight of deposits in their financing structure, along with the lower need for funds, given the deleveraging by households and firms, has affected the rate of debt issuance on the financial markets. However, in January 2014 two banks from Groups 1 and 2 successfully issued debt on the market, reflecting the improvement in market sentiment and the increase in confidence in Spanish banks, including those that needed State aid.

Activity on the interbank markets has remained weak

Since the last issue of the FSR the euro area interbank markets have not seen significant changes. Their activity has remained weak, at levels below those of previous years. Chart 2.8.B shows EONIA trading volumes. After bottoming out at the end of 2012, these began to rise again in 2013, albeit relatively moderately and discontinuously. The Spanish interbank market behaved similarly.

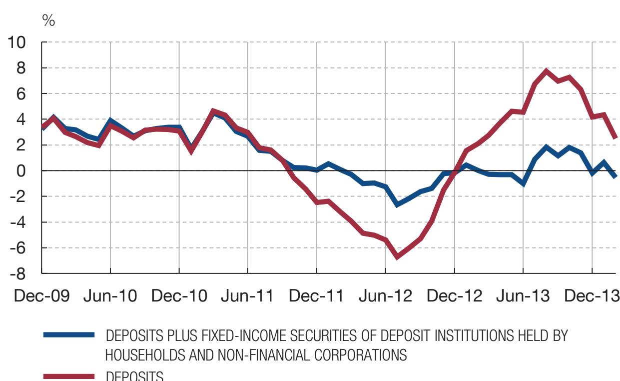
Spanish banks continued to reduce their gross recourse to the Eurosystem in 2013

Owing to the lack of activity on the **interbank markets,** and the unlimited provision of liquidity by the Eurosystem, European credit institutions have continued to resort extensively to Eurosystem funds. That said, their recourse to these funds also remained on the downtrend, which began in summer 2012, when the ECB Governing Council announced the launch of the programme for the purchase of securities in the secondary markets for euro area sovereign debt. Since then, the ability of European banks to raise funds on the primary markets has improved considerably, allowing them to lower their purchases in new tenders and to begin repaying early a portion of the funds received in the two 3-year tenders allotted in late 2011 and early 2012. Chart 2.8.C shows the outstanding balance of the ECB tenders for the total Eurosystem and for banks resident in Spain. It shows how, between the end of March 2013 and the end of March 2014, banks resident in Spain reduced their gross recourse to the Eurosystem by €85 billion (–32%), while the outstanding balance in the total Eurosystem decreased by €263 billion (–29%).

Consequently, the share of loans to Spanish banks in the total Eurosystem decreased slightly in this period. The percentage of tender allotments to Spanish-resident banks with respect to the total provided by the Eurosystem was 28.5% on average in March 2014, while the figure for March 2013 had been 29.4%.

DEPOSITS FROM HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS — CHART 2.9
Business in Spain, ID. Deposit institutions

A. YEAR-ON-YEAR RATE OF CHANGE



B. LOAN-TO-DEPOSIT RATIO IN RELATIVE TERMS (a)

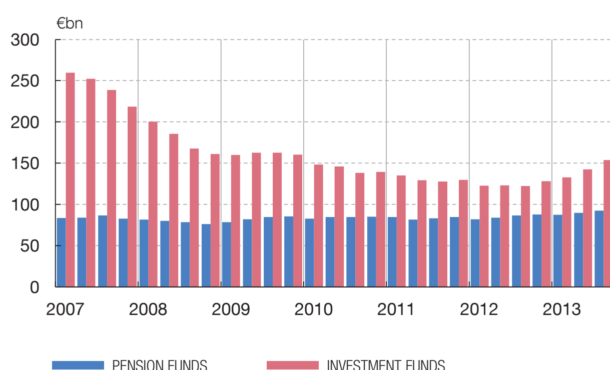
SOURCE: Banco de España.

a Loans to households and non-financial firms net of provisions. Deposits from households and non-financial firms plus fixed-income securities of deposit institutions held by households and non-financial firms.

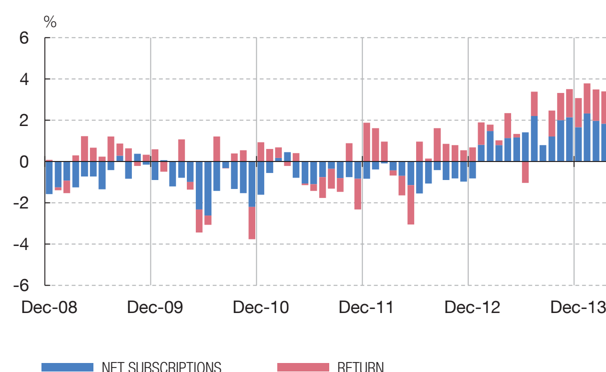
INVESTMENT AND PENSION FUNDS

CHART 2.10

A. ASSETS OF INVESTMENT FUNDS AND PENSION FUNDS



B. CONTRIBUTION TO CHANGE IN NET ASSET VALUE OF RETURNS AND OF NET SUBSCRIPTIONS



SOURCE: INVERCO.

Deposits from households and non-financial corporations rose during 2013

With regard to the **retail funds** raised by deposit institutions, the deposits from households and non-financial corporations increased during 2013 by 4.2% with respect to December 2012. Their year-on-year growth rate was positive in every month, increasing to August when it peaked at 7.7% (see Chart 2.9.A). The latest data available, for February 2014, show a year-on-year rate of change of 2.5%.

Also taking into account the fixed income securities issued by institutions and held by households and non-financial corporations, retail financing has remained relatively stable

By contrast, other fixed-income instruments issued by banks, such as notes held by households and non-financial corporations, continued to decline. This trend dated back to summer 2012, when contributions to the Deposit Guarantee Fund were changed again and the incentives that had made notes attractive relative to deposits eliminated. During 2013 this type of fixed-income security declined progressively, especially in the first three quarters. As a result, joint consideration of the deposits and fixed-income securities of deposit institutions held by households and non-financial corporations shows that retail funds remained relatively stable during 2013.

This stability, along with sustained deleveraging, is leading to further narrowing of the retail funding gap

The stability of the deposits and fixed income securities of deposit institutions held by households and non-financial corporations in 2013, along with the on-going deleveraging by these sectors, is leading to a further narrowing of the difference between lending and deposits, a development that is also visible at the consolidated level, as mentioned above at the beginning of Chapter 2. That is to say, the progressive correction in the retail funding gap is continuing (see Chart 2.9.B). The rate of decline during 2013 was in line with that observed over the last five years (since 2009), except in December 2012, when it was steeper as a consequence of the asset transfer by Group 1 banks.

The net assets of pension funds and, above all, of investment funds increased in 2013, especially in the second half of the year

In 2013 the net assets of investment funds and pension funds increased (see Chart 2.10.A). The increase, for both types of fund, was greater in the second half of the year. Specifically, pension funds increased by more than €2 billion in each of the last two quarters of the year. In the case of investment funds, the rise was greater. In the first two quarters the quarterly rise was close to €5 billion, while in the latter two quarters it doubled, exceeding €11 billion in Q4. This increase is due to the positive returns and the increase in net subscriptions, although the latter largely explain the rise in net assets (see Chart 2.10.B). The increase in 2013 in net subscriptions was seen across all types of fund. Fixed-income funds, both short and long-term, passive funds and international funds lead these rises, while guaranteed funds are the only ones that have been significantly reduced in 2013.

2.2 Profitability

Deposit institutions recorded consolidated income of €11,101 million in December 2013 as against significant losses a year earlier

Deposit institutions recorded income attributable to the controlling entity of €11,101 million in December 2013 (see Table 2.2), as compared with losses of more than €43 billion the previous year. This improvement in the income of the system as a whole is largely attributable to the institutions belonging to Groups 1 and 2, which recorded heavy losses in 2012, owing to the significant increase in provisioning in 2012 to comply with the requirements of Royal Decree-Laws 2/2012 and 18/2012, and have obtained profits in 2013. The attributable income of other deposit institutions also improved in 2013, again largely owing to the lower provisioning required in comparison with 2012. This general fall in provisioning offset the decline in business margins, in particular the net interest margin, which was under pressure from declining lending, low interest rates and rising NPLs.

Net interest income decreased in year-on-year terms…

Net interest income decreased 9.8% year-on-year in 2013 with falls in both financial revenues (–12.3%) and financial costs (–14.7%). Its weight in average total assets (ATA) fell from 1.81% in December 2012 to 1.71% a year later.

…due to the reduced volume of activity and low interest rates

This decline in net interest income was due, particularly, to the performance of business in Spain, where it declined by about 20%. Similarly, in Spain the difference between the average return on investments and the average cost of liabilities continued to narrow (see Chart 2.11.A). The fall in net interest income is explained by the ongoing reduction in lending which had a negative impact during 2013, but especially by the decline in the interest rate spread (price effect, see Chart 2.11.B). In new transactions there was a s light rise in the spread between assets and liabilities (see Chart 2.11.C) which favours the margins on new business.

CONSOLIDATED INCOME STATEMENT TABLE 2.2
Deposit institutions

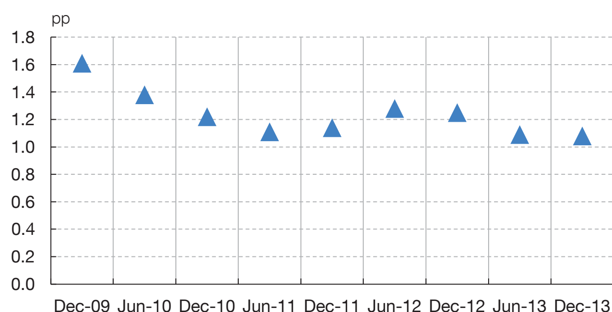
	Dec-13		Dec-12	Dec-13
	€m	% Change Dec-13/Dec-12	% ATA	% ATA
Financial revenue	118,976	-12.3	3.61	3.34
Financial costs	57,834	-14.7	1.81	1.62
Net interest income	61,142	-9.8	1.81	1.71
Return from capital instruments	1,156	-24.5	0.04	0.03
Share of profit or loss of entities accounted for using the equity method	4,352	41.2	0.08	0.12
Net commissions	22,736	-3.5	0.63	0.64
Gains and losses on financial assets and liabilities	13,519	65.1	0.22	0.38
Other operating income	-3,311	—	-0.08	-0.09
Gross income	99,593	-1.4	2.69	2.79
Operating expenses	50,516	0.9	1.33	1.42
Net operating income	49,078	-3.6	1.36	1.38
Asset impairment losses (specific and general provisions)	32,320	-62.7	2.31	0.91
Provisioning expense (net)	4,819	-39.3	0.21	0.14
Operating profit	11,939	—	-1.16	0.33
Asset impairment losses (assets other than loans and credits)	6,448	-64.9	0.49	0.18
Income from disposals (net)	5,945	—	-0.01	0.17
Profit before tax	11,436	—	-1.66	0.32
Net income	13,414	—	-1.41	0.38
MEMORANDUM ITEM				
Income attributable to the controlling entity	11,101	—	-1.17	0.31

SOURCE: Banco de España.

PROFITABILITY
Deposit institutions

CHART 2.11

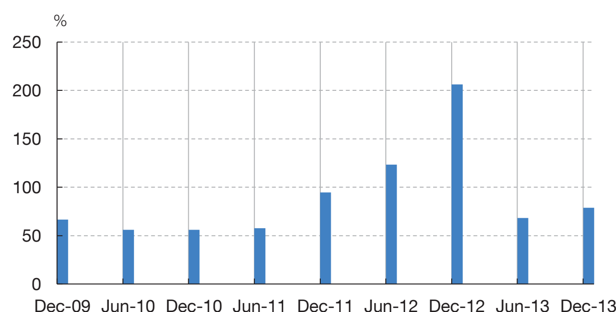
A. DIFFERENCE BETWEEN AVERAGE PROFITABILITY OF INVESTMENTS AND AVERAGE COST OF LIABILITIES, ID



B. PERCENTAGE OF THE CHANGE IN NET INTEREST INCOME EXPLAINED BY EACH FACTOR, ID

C. MARGINAL INTEREST RATES OF ASSETS AND LIABILITIES, ID (a)

D. PERCENTAGE OF NET OPERATING INCOME REDUCED BY ASSET IMPAIRMENT LOSSES



SOURCE: Banco de España.

a Marginal interest rates refer to those established in operations started or renovated in the previous reference month. The operations are weighted according to their volume. Weighted marginal interest rates of assets include, among others, those for housing, consumption and credit to non-financial corporations, while the liabilities rates include fixed-term deposits and repos, among others.

Net commissions declined in December 2013…

The year-on-year rate of change in net commissions decreased by 3.5% in December 2013 mainly due to business abroad which declined by 5.8% compared with a fall of 0.9% for consolidated business in Spain. Nevertheless, its weight in ATA increased by 1 bp to 0.64% as of the same date. As for activity in Spain, commissions for collection and payment services and those from securities fell slightly while those associated with the marketing of non-bank financial products grew.

… while gains and losses on financial assets and liabilities rose, partly owing to one-off effects

The gains and losses on financial assets and liabilities climbed by 65.1% year-on-year and their relative weight in ATA rose to 0.38% (0.22% in December 2012). This improved performance was due, first, to the sale of available-for-sale financial assets and, second, to the effect of hybrid instrument management exercises.

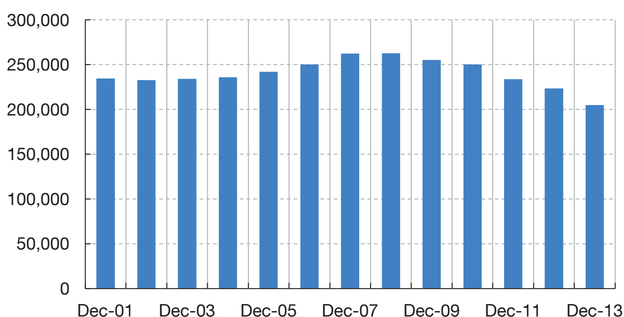
Banks have continued to adjust capacity by reducing the number of employees and offices

Operating expenses grew by 0.9% in December 2013 compared with the same period in 2012, particularly due to higher staff and depreciation expenses. Staff expenses grew essentially in this period as a result of the staff compensation expenses incurred by one institution conducting capacity adjustment processes. Excluding that institution, operating

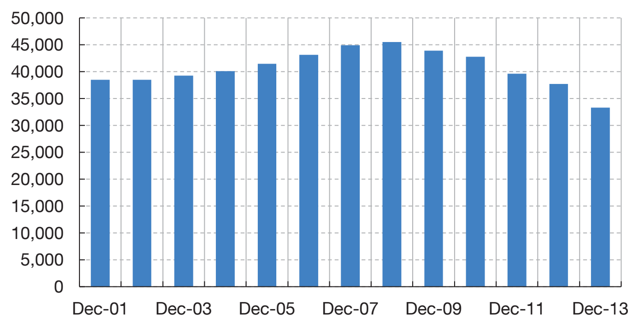
NUMBER OF EMPLOYEES AND OFFICES. BUSINESS IN SPAIN
Deposit institutions, ID

CHART 2.12

A. EMPLOYEES



B. OFFICES



SOURCE: Banco de España.

expenses would have decreased by 1.2% year-on-year. The weight of operating expenses as a percentage of ATA increased to 1.42% (1.33% in December 2012). The efficiency ratio held at relatively stable levels and rose by 1 pp to 50.7% in December 2013. In business in Spain, in keeping with the required process to adjust capacity and cut operating costs, there were further reductions in the number of employees and offices (see Charts 2.12.A and B).

Asset impairment losses continued to erode a large percentage from net operating income, but they have fallen significantly with regard to 2012 following the substantial provisioning in that year as a result of RDL 2/2012 and RDL 18/2012

Asset impairment losses (specific and general provisions) fell by 62.7% in December 2013. There was also a very large decline in the weight of these items in ATA from 2.31% of ATA in December 2012 to 0.91% a year later. It should be noted that in 2012 provisions were recorded pursuant to RDL 2/2012 and RDL 18/2012, which explains that although NPLs have continued to rise, as indicated above, provisions in comparison with 2012 have decreased.

Impairment losses on other assets, due to the above-mentioned reasons, showed a similar trend to previous years and fell substantially by 64.9% in 2013 compared with 2012 and, consequently, their weight in ATA decreased to 0.18% (from 0.49% in December 2012).

Overall, impairment losses eroded 79% of operating income in December 2013 (see Chart 2.11.D). This percentage is relatively high, although from the perspective of a longer time horizon it appears more normal.

In short, the results of Spanish deposit institutions showed a recovery in 2013 with respect to 2012, mainly due to the decrease in impairment losses, following the substantial provisioning efforts by banks in the previous year. The decline in net interest income owing both to the fall-off in activity and, especially, low interest rates poses a challenge for banks with a view to 2014, when they will have to move ahead with their adjustment process of operating costs so as to achieve higher profitability.

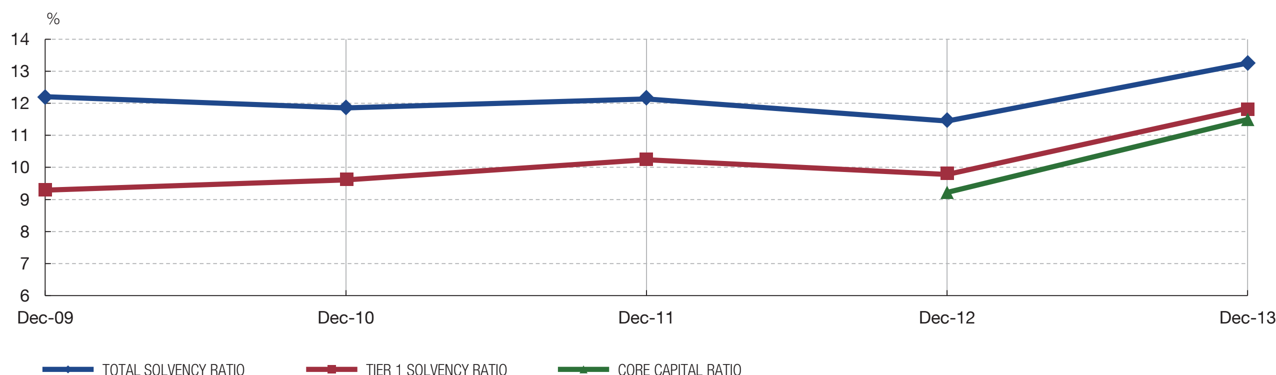
2.3 Solvency

Solvency ratios rose in 2013 for deposit institutions as a whole

The **aggregate solvency ratio of all Spanish deposit institutions** rose in December 2013 by 1.8 pp in a year to stand at 13.2%. In the same direction and more markedly, the tier 1 ratio stood at 11.8%, 2.1 pp above its level at the same date a year earlier. The core capital ratio, which reflects the highest quality capital in accordance with the definition and criteria laid down by Law 9/2012, implemented by CBE 7/2012, and which adheres to EBA recommendation 2011/1, rose from 9.2% in December 2012 to 11.5% at end-2013 (see Chart 2.13).

SOLVENCY
Deposit institutions

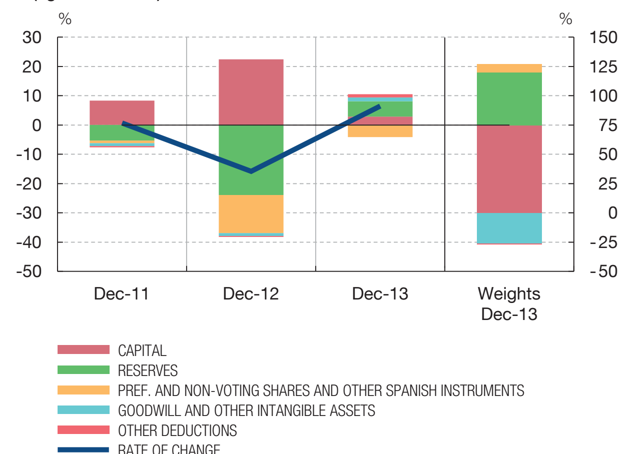
CHART 2.13

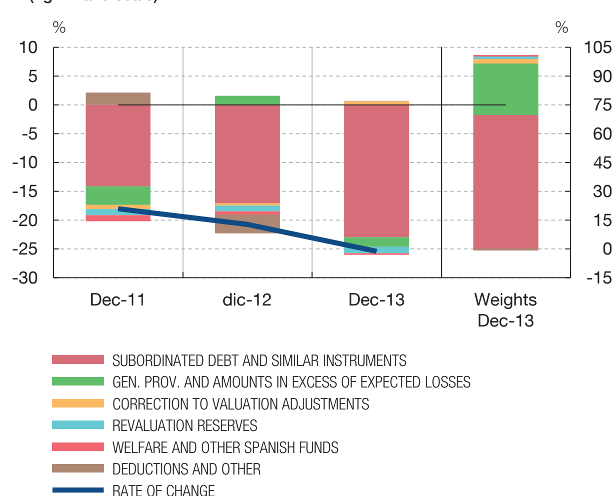


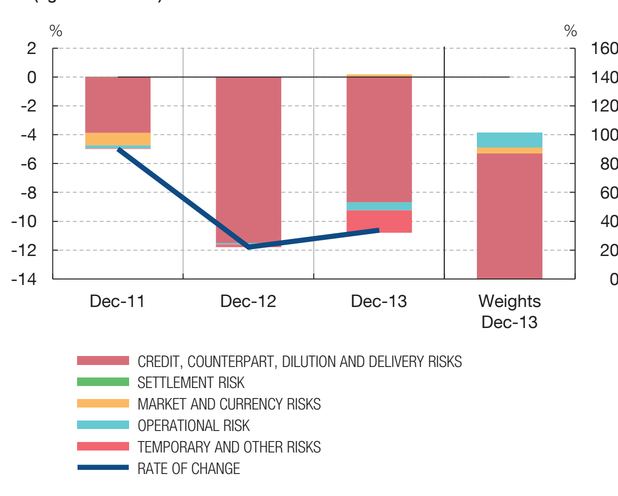
SOURCE: Banco de España.

CAPITAL REQUIREMENTS AND OWN FUNDS
Deposit institutions

CHART 2.14





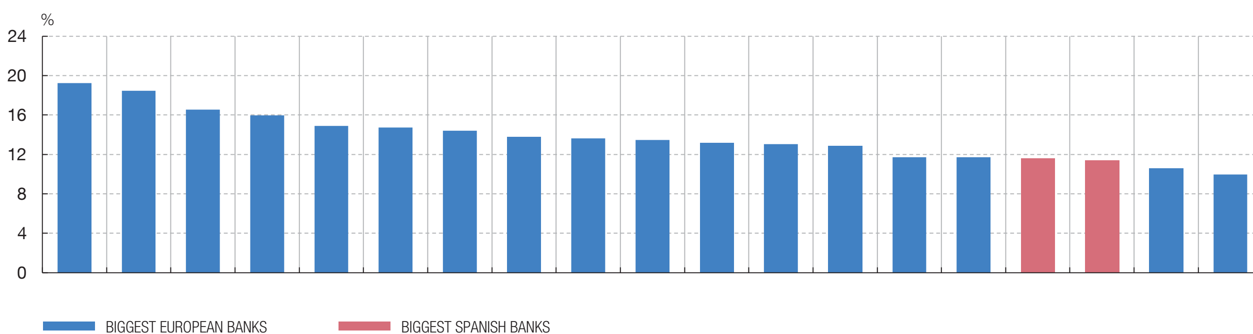


SOURCE: Banco de España.

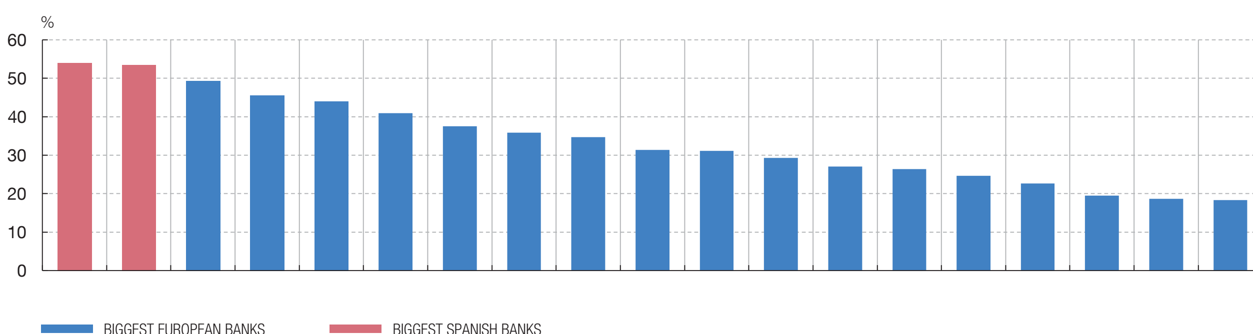
SOLVENCY OF THE BIGGEST EUROPEAN BANKS (a)

CHART 2.15

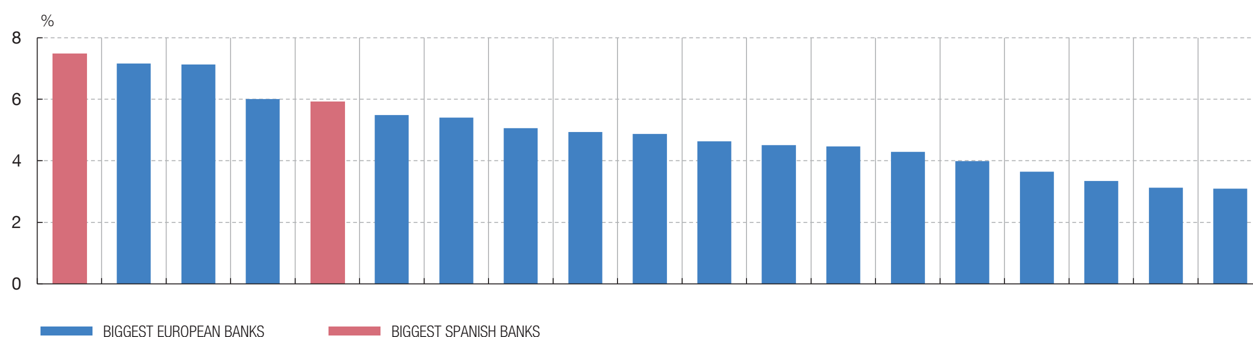
A. CORE CAPITAL RATIO. DECEMBER 2013



B. RWA AS A PERCENTAGE OF TOTAL ASSETS. DECEMBER 2013



C. TOTAL EQUITY AS A PERCENTAGE OF TOTAL ASSETS. DECEMBER 2013



SOURCE: SNL Financial.

a The biggest banks in Spain, France, Italy, Germany, United Kingdom, Switzerland, Netherlands, Portugal, Denmark and Sweden are taken. Each panel depicts the banks in descending order for the variable in question.

Total own funds rose in 2013, owing both to the increase in tier 1 capital and to lower deductions

Total own funds grew in 2013 at a rate of 3.5%, compared with a 16.8% decline in 2012. This growth came about owing both to the increase (6.4%) in tier 1 capital and to the positive contribution of lower deductions,[7] and despite the fact that tier 2 capital continued to diminish (–25.4%), becoming increasingly more relegated under own funds that seek to prioritise the quality of their components (see Chart 2.14.A).

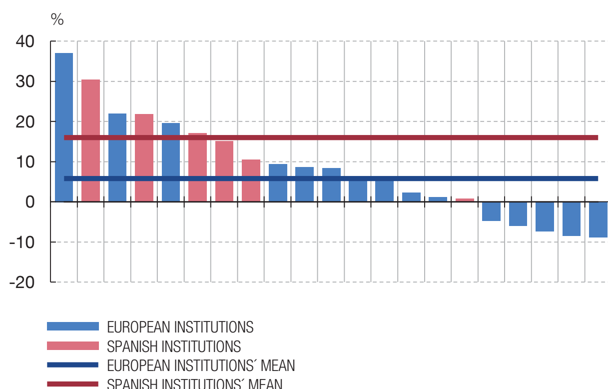
Notable under tier 1 capital was the 12.3% increase in reserves in December 2013, following two years of decline, the outcome of the positive results at the end of the year.

7 Box 2.3 analyses the changes in deferred fiscal assets for the purposes of solvency and which come into force on 1 January 2014.

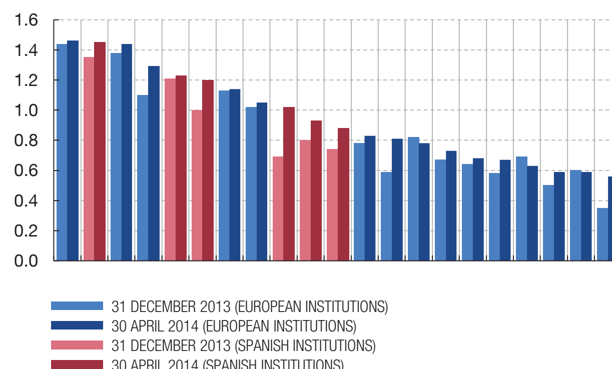
MARKET INFORMATION
International comparison (a)

CHART 2.16

A. STOCK MARKET CHANGE BETWEEN 31 DECEMBER 2013 AND 30 APRIL 2014 (b)



B. PRICE-TO-BOOK VALUE RATIO. BIGGEST EUROPEAN INSTITUTIONS (c)



SOURCE: Datastream.

a Nationalised institutions are excluded in all countries.
b Each bar represents an institution.
c Each pair of bars represents an institution.

Capital slowed down but maintained growth of 3.7%, while preference shares continued to decline (–35.5%; see Chart 2.14.B), partly as a result of the burden-sharing exercises in the restructuring and recapitalisation of ailing institutions.

The fall-off in lower-quality capital compared with that of higher quality continues

The negative growth in subordinated financing quickened, posting a 31% decline. That caused a fall-off in tier 2 capital, largely the result of the contribution to the recapitalisation of ailing institutions. The aim of Basel III is that banks' capital base should be of higher quality, meaning that the weight of tier 2 capital will tend to be increasingly less. Meanwhile, the general provisions eligible as own funds fell by 7.6% (see Chart 2.14.C).

Risk-weighted assets fell, although less so than in 2012, in line with the decline in credit

Risk-weighted assets posted a smaller decline in December 2013 than at the end of the previous year (–10.6% against –11.8%) since credit risk requirements, with a weight of 87% in total requirements, fell once again (–10%) but less so than in 2012 (–13.1%) (see Chart 2.14.D). The decline in 2013 continued to reflect the ongoing deleveraging of households and firms in Spain, along with a certain shift in the asset mix of institutions' consolidated balance sheet.

Spanish institutions are in a relatively low position regarding capital ratios, although the situation is reversed when comparing their degree of leveraging

The larger Spanish institutions have capital ratios that are ranked low when set against comparable European peers, although these ratios do in any event exceed 11.5% (see Chart 2.15.A). The situation is reversed when comparing solvency ratios based on the leverage ratio (capital to book assets), a metric were Spanish banks are in a relatively high position compared with their European counterparts (see Chart 2.15.C). Moreover, risk-weighted assets account for a greater weight in total assets at Spanish institutions (Chart 2.15.B).

In 2014 to date, Spanish institutions' share prices have trended favourably, outperforming other comparable European institutions

In 2014 to date, the share prices of the main Spanish banks have continued on the favourable trend seen in recent months (see Chart 2.16.A). Against a backdrop of improved banking sector share prices across Europe, those of Spanish banks have outperformed those of comparable European institutions. As a result, the institutions' price-to-book ratio continues to improve. From the standpoint of this ratio, the main Spanish private-sector banks are in a medium-high position compared with the main institutions at the European level (see Chart 2.16.B).

The new solvency rules (CRR and CRD IV), which were approved in June 2013 and entered into force in January 2014, provide that banks' deferred tax assets (DTAs) that are dependent on future income must be deducted from regulatory capital (specifically top quality capital, common equity Tier 1 - CET1). Under these rules, the supervisor is allowed to gradually include the deduction in the calculation of the capital ratio so as to ensure a suitable transition to the new regulatory framework.

This deduction had a greater impact in Spain than in most European countries owing, among other reasons, to the restrictive nature of Spanish tax law which was apparent in two respects.

First, in relation to the treatment applicable in the event that a company reports a loss on its financial statements. In some countries, when a firm reports a loss, the tax authorities refund some of the taxes it has paid in previous years, subject to a time limit. In Spain, the firm must earn profits in subsequent years in order for this offset to take place.

Second, tax law does not recognise large amounts recorded as costs in the accounts as tax-deductible expenses. A typical example is the general provisions made by Spanish banks, most of which are not considered to be tax-deductible costs. With the publication of Royal Decree Laws (RDLs) 2/2012 and 18/2012, which required the recording of extraordinary provisions for the real estate sector, the volume of DTAs arising from provisions increased significantly.

The amendment to the Corporate Income Tax Law approved by RDL 14/2013, which is applicable to all firms, makes the playing field level for Spanish credit institutions in competition with their European Union counterparts.

With this amendment, mechanisms are envisaged to ensure that firms recover the amount of tax assets arising from temporary differences (accounting expenses not accepted as a tax expense when they are incurred, but that will be accepted as such in future) which have arisen from provisions for loan losses or foreclosed assets or from commitments due to pension expenses. Although they will continue to be recovered in general, as has been the case to date, through the reversal of the temporary differences, another possibility is envisaged which is described below.

In fact, if it became necessary, the offsetting of the balances referred to by the new rule against other tax debts or the refund of such amounts would be permitted. This new mechanism will be activated only in very restrictive cases: fully, should a firm become insolvent or be wound up; and in the case of accounting losses, limited to a proportion equal to the ratio of losses to owns funds. If the DTAs included in the scope of the rule are not reversed within 18 years, they may be exchanged for government debt securities.

To correctly assess the scope of this amendment, it must be considered that:

1. The nature of Spanish tax law does not change substantially and it will continue to be demanding when accepting that an expense is tax-deductible.

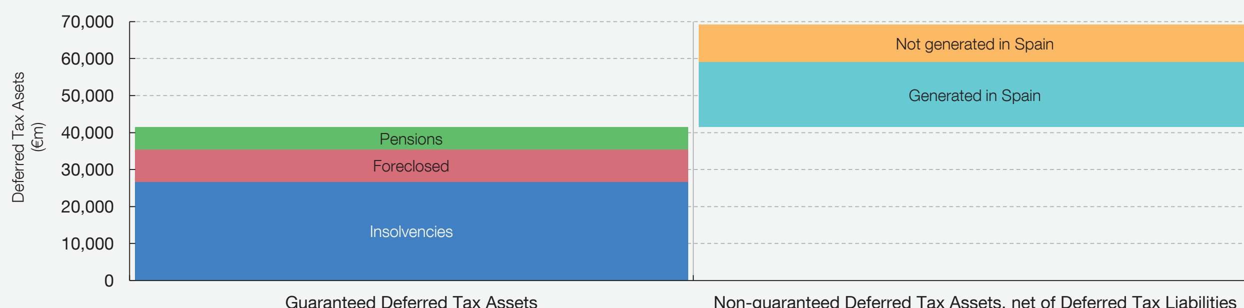
2. The practice followed by several EU countries, of refunding taxes paid in previous years when a firm reports a loss, will not be adopted.

3. The possibility of repayment of tax assets, through the new mechanism, has a limited scope, since it does not cover all tax assets but only those that have the nature of temporary differences and have arisen from provisions for loan losses or foreclosed assets, or pension expenses.

4. Based on estimations, the likelihood that one of the situations triggering the repayment of the DTAs would occur – with the subsequent effect on tax revenue - is very low.

The DTAs recorded in the balance sheets of Spanish credit institutions at end-2013 amount to around €77 billion and there are also €9 billion of deferred tax liabilities (DTLs). Therefore, the net figure stands at €68 billion (see Panel A), approximately 60% of which is included in the scope of application of the new tax rule.

A. DEFERRED TAX ASSETS OF THE 16 MAIN SPANISH BANKING GROUPS



SOURCE: Banco de España.

This change to the tax rule incorporates into Spanish legislation (following the line taken in other EU countries) the case that is specifically included in the CRR, that since DTAs do not depend on future income, they must not be deducted from the calculation of the solvency ratio.

As indicated at the beginning of this box, the new solvency rules envisage a series of transitional adjustments in the early years to facilitate its entry into force, with the result that 10% of the full amount of the DTA deduction will begin to be claimed in 2015 and will be increased by a further 10% each year until it has been fully deducted by 2024. In 2014 banks do not yet have to make DTA deductions.

This chapter is devoted to three different matters, with – likewise different – implications for the banking sector. The first section of the chapter conducts a study of the impact on bank lending of the regulatory change to the new definition of SMEs and the amendments to the capital requirements associated with this type of financing. The second section briefly reviews the macroprudential instruments included in CRD IV and CRR, and reports on the latest measures taken by the European Systemic Risk Board (ESRB) in this connection. Finally, the third section reports on the latest developments in relation to the Single Resolution Mechanism in Europe. Completing the chapter is a box on the recent changes in insolvency legislation.

3.1 Analysis of the impact on lending of the new capital requirements and the change in the definition of SMEs

Among the range of measures designed to facilitate the financing of Small and Medium-Sized Enterprises (SMEs) in Spain, the Law on Support to Entrepreneurs (Law 14/2013) approved, in late September 2013, a new regime for financial institutions' capital requirements in exposures to SME credit risk. This anticipated by three months the entry into force of the rules envisaged in the *Regulation (EU) on the prudential requirements of credit institutions* (CRR, 575/2013). Around the same date, Banco de España Circular 4/2013 aligned for regulatory purposes the Spanish definition of SMEs with that prevailing at the European level. This entails two potentially far-reaching changes.

Circular 4/2013 broadens the regulatory definition of SMEs in Spain, adapting it to that adopted by the European Commission

Circular 4/2013 broadens the regulatory definition of SMEs in Spain to adapt it to that adopted by the European Commission. Specifically, under the definition currently in force a company is considered an SME if, in the year of reference, it has fewer than 250 employees and, moreover, its net turnover does not exceed €50 million or its total assets are below €43 million, taking into account whether the firm is part of a holding company or is independent. The previous regulations required compliance for two consecutive years with two out of three much stricter requirements: a) a workforce of fewer than 50 employees; b) net turnover of less than €5.7 million; and c) total assets below €2.85 million. As a result, loans to firms with SME status under the new definition record a reduction in the associated capital requirements. This is due to the fact that they are now classified in the regulatory category of retail exposures, the weight of which in the calculation of risk-weighted assets is less (for example, in the case of the standardised approach, this involves moving from a weighting of 100% to one of 75%).

Furthermore, capital requirements for loans to SMEs are reduced

The Law on Support to Entrepreneurs anticipated by three months the entry into force of the European capital regulations relating to the treatment of capital requirements for SMEs. Thus, it reduces capital requirements for new and existing loans, excluding unpaid positions, to all SMEs by 25%. For the application of this rebate, additional flexibility is given to the definition of SMEs, since only compliance with the requirement in respect of net turnover (less than €50 million) is demanded. Moreover, the ceiling on the total exposure a financial institution can have to the SME (excluding loans secured by real estate) for this consideration to hold good is raised from €1 million to €1.5 million.

In the following paragraphs the firms that become SMEs for regulatory purposes are characterised by either or both of the two measures (but without distinguishing, owing to a lack of information, whether such firms are independent or not) and it is analysed whether, in the months elapsed since the approval of the Law, there is a detectable and significant impact on developments in credit to SMEs as compared to other companies.[1]

1 This section summarises some of the findings of the research paper "Bank Capital and Credit Supply: SMEs and Basel III in Spain", by A. Estrada, G. Jiménez and J.L. Peydró.

On 7 March this year Royal Decree-Law 4/2014 was approved, amending the Law on Insolvency law in order to help business restructuring processes take place irrespective of insolvency proceedings. The aim thereby was to boost the deleveraging of that part of the Spanish business system that is subject to high financial pressure but which is still viable.

Law 38/2011 had already introduced into insolvency legislation specific regulations for pre-insolvency principles, providing certain safeguards to refinancing agreements, although the reform failed to achieve the desired result because it did not in practice put on a firm basis the signing and, in particular, the court approval of such refinancing agreements.

Refinancing agreements

Royal Decree-Law 4/2014 therefore firstly eliminates some of the formalities that made refinancing agreements costlier; significantly, it eliminates the requirements that refinancing agreements should be previously informed by an independent expert appointed by the Mercantile Register. Further, Royal Decree-Law 4/2014 introduces a new category of refinancing agreements, for which it also provides safeguards in the event that the company should go into insolvency. These are agreements in which it is not necessary for the signatory creditors to represent a specific majority of the debt of the company in difficulty and, therefore, to avoid abuse, the rule establishes very stringent requirements so that such agreements may benefit from protection.

Approval of refinancing agreements

Royal Decree-Law 4/2014 also amends the legal regime applicable to those refinancing agreements that are approved by the courts, substantially extending the scope of the effects of such approval.

Of note, first, is the extension of the types of creditors potentially affected by the approval: following the entry into force of Royal Decree-Law 4/2014, creditors holding any type of financial debt, whether subject or not to supervision, may be affected by the approval.

Secondly, Royal Decree-Law broadens the range of commitments that may be laid down in refinancing agreements and whose effects may extend to financial debt creditors who have not voted in favour of the agreement. Here, in addition to delays or the halting of enforcements, the following may be imposed: haircuts, the conversion of loans into shares or participations, or into equity loans, convertible bonds or subordinated loans or loans with capitalisable interest or other financial instruments whose seniority, maturity or characteristics differ from the original instruments, and also the assignment of goods and entitlements as payment. Royal Decree-Law 4/2014 specifies the majorities that must be reached in each instance for the agreement to extend to the financial debt creditors as a whole.

Significantly, the commitments assumed in the refinancing agreement may now even affect creditors whose loans are secured by real assets: on one hand, the new regulation makes it clear that, for the portion of the loan that is not secured (to this end specific valuation rules are set), the effects of the approval by the courts are applied under the same conditions as for unsecured loans; and, on the other, these effects may be extended even to the portion of the loan that is covered by the collateral, provided that certain qualified majorities are reached (calculated in this case in relation to the total value of the secured debt). Royal Decree-Law 4/2014 also introduces specific provisions applicable in relation to syndicated loans or credits, aimed at preventing blocking minorities within the syndicate from hampering refinancing agreements being reached.

Other changes

So as to enable refinancing agreements to be more readily concluded, Royal Decree-Law 4/2014 suspends or paralyses judicial enforcement procedures on goods that are necessary for the continuity of the debtor's professional or business activity as from the time the debtor presents notice of pre-insolvency to the courts, for the period envisaged in insolvency law for the negotiation of the agreement. Further, and along with other measures aimed at promoting the contribution of fresh money by creditors and shareholders to the company in difficulty, Royal Decree-Law 4/2014 stipulates that, for two years as from its entry into force on 9 March 2014, loans extended under a refinancing agreement that entail fresh money shall be considered as claims against the debtor's estate for the whole of their amount, and not for up to 50% as was the case under the previous regulations.

Classification of restructured credit risk

The Banco de España, in compliance with the first additional provision of Royal Decree-Law 4/2014, has approved criteria relative to the application of the provisions in Circular 4/2004, regarding the accounting treatment of the amounts due following a refinancing agreement in keeping with those regulated in Art. 71 bis and in the fourth additional provision of the Law on Insolvency. The current value of these amounts will be classified as a standard exposure insofar as there are sufficient objective factors to confirm the likelihood of their recovery following the refinancing agreement, and as this agreement is in response to a viability plan that allows for the continuity of the professional or business activity in the short and medium term. In this connection it will be particularly important to assess the effect that debt reductions, payment schedule amendments and debt-to-capital conversions may have on the possibilities of recovering the amount due, bearing in mind the new business plan of the obligor. If there is evidence of insufficiency in the future cash flows needed to meet the commitments assumed following the refinancing agreement, institutions should classify the amounts due under an accounting category of higher risk, with the appropriate recognition of provisions.

It is estimated that the new SMEs employ 2.4 million workers, generate 27% of value added and receive 50% of business bank credit

The extrapolation of the corporate data in the SABI database suggests that companies employing around 2.4 million people and that generate 27% of the value added in the private sector have come to be considered as SMEs. The new SMEs concentrate more than 50% of total bank credit to firms. By sector, the biggest percentage of new SMEs is in industry and in business services, the sectors of activity which have in recent years led productivity growth, and, to a lesser extent, in construction and real estate services.

These firms are more competitive and financially more robust than those that met the earlier, more restrictive criteria

These new SMEs are bigger than those that met the more restrictive criteria (on average they hire ten times as many employees and turnover is fifteen times higher). They are also more productive and have more diversified markets, since 36% of them export part of their output, compared with 7% of the former SMEs. From a financial perspective, the new SMEs are also more robust than their predecessors. For instance, the ordinary return on their investment is almost 3 pp higher and, by contrast, the related interest-bearing cost is very similar. Finally, the new SMEs show a similar level of debt (56.9% against 56.3%).

The statistical exercise involves comparing the growth of bank credit to SMEs as opposed to that to large corporations before and after the regulatory change

To analyse whether the freeing up of funds for credit institutions that these regulatory changes have entailed has made for a greater extension of credit to SMEs, a model is used that compares the change in the credit committed to an SME in the financial system before and after September 2013 (when the new regulations came into force) to that granted to a large corporation (for which the regulations have not changed). The exercise takes into account both observable characteristics of the firms and observable and non-observable characteristics of the bank that may influence the credit obtained by the firm. Foreseeably, before the entry into force of the regulatory change, being classified as an SME exerted no differential effect (unless banks were anticipating the entry into force of the new regulations).

Two approaches are used. The first is labelled “local”, since it considers the exclusive relations between each firm and the habitual bank that provides it with financing. The second, “aggregate” approach analyses the total volume of bank credit obtained by a firm. Both approaches complement one another. The first tests whether, following the regulatory change, banks are lending more to their habitual customers. The second tests whether the firm obtains more loans from its habitual bank or from others. Consequently, this second approach is linked to the overall impact of the measure. Firms with defaults have been stripped out of the statistical exercise, since the rebate on capital requirements is not applicable to them. Further, to avoid potential distortions owing to the particular behaviour of the construction and real estate development sector, these firms are also excluded from the study. Owing to the lack of necessary information, the possibility that the SMEs are associated or related undertakings cannot be taken into account. This means that the results obtained are a scale down from the real effects, since included among the SMEs are firms that would not be considered as such and for which the regulations would not have changed. As regards financial institutions, data on the Group 1 and 2 banks are not compiled owing to the fact that they are subject to particular measures relating to restructuring and to the adjustment of their business volume.

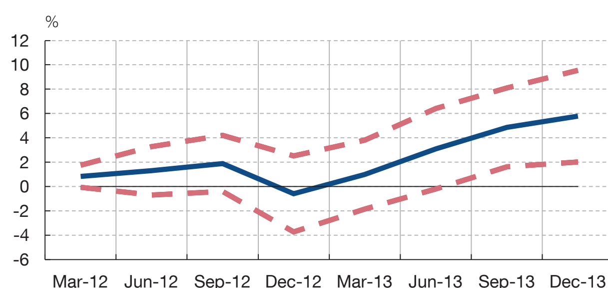
The results presented below should be interpreted with all due caution. First, as indicated, certain information shortcomings remain which prevent the set of companies subject to the measure from being precisely defined. Further, what is involved is an impact study based on econometric analysis techniques for which, moreover, a relatively short period of time is available as from the introduction of the measures whose impact is the subject of interest.

Following the reform, the growth of credit extended by...

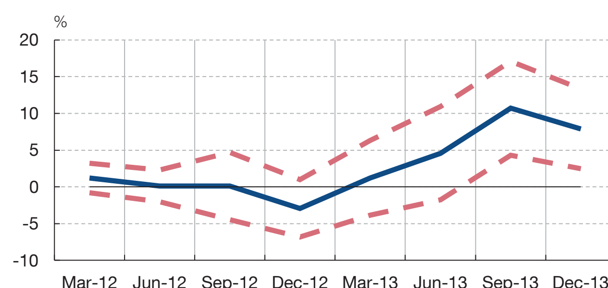
Commencing with the first (local) approach, Chart 3.1.A shows the relative growth of credit to SMEs and large corporations for the different periods analysed. It can be seen how this

ESTIMATION OF THE REGULATORY CHANGE'S EFFECT ON SMEs CREDIT — CHART 3.1

A. RELATIVE GROWTH OF CREDIT TO SMEs VERSUS LARGE FIRMS. LOCAL FOCUS. ESTIMATED EFFECT AND CONFIDENCE INTERVALS



B. RELATIVE GROWTH OF CREDIT TO SMEs VERSUS LARGE FIRMS. AGGREGATE FOCUS. ESTIMATED EFFECT AND CONFIDENCE INTERVALS



SOURCE: Banco de España.

... the habitual bank to an SME is 5.8 pp higher than that to a standard major corporation...

coefficient is statistically significant as from 2013 Q3 and reaches a value of 5.8% at the end of that year. This would indicate that the growth rate of credit extended by the habitual bank that finances an average SME, compared with that to a major corporation, would be 5.8 pp higher after the regulatory change.

… while at the aggregate level the impact is 7.9 pp higher

Using the aggregate approach, Chart 3.1.B shows that the relative growth of credit for SMEs and large corporations shifts from not being statistically significant before the reform to being so after it. Moreover, the discrete estimation of this parameter in December stands at 7.9%, higher than that found under the local approach. This suggests that banks other than those that were already working with an SME have begun to grant new credit, apart from the fact that SMEs are drawing down more credit from their traditional banks, as shown by the analysis at the local level.

Accordingly, and bearing in mind the limitations proper to this type of analysis, the results suggest that the regulatory changes set in place since 2013 Q3 appear to have had a favourable differential impact on the relative growth of credit to SMEs as opposed to large corporations. These results do not differ significantly if listed companies, which may have obtained financing through channels other than banks, as explained in Chapter 2, are excluded from large corporations.

3.2 Macroprudential instruments

Macroprudential policy, to meet its goal of contributing to safeguarding the stability of the financial system as a whole, has various instruments at hand…

The ultimate aim of macroprudential policy is to contribute to safeguarding the stability of the financial system as a whole, by means of strengthening the system's resilience and mitigating systemic risks, thus ensuring a sustainable contribution by the financial sector to economic growth. To achieve this goal the macroprudential authorities can use a series of measures, including warnings, recommendations and actions in respect of specific macroprudential instruments.

In the past few years, partly as a result of the recent financial crisis and the need for specific measures to counter systemic risks, interest has stepped up on the use of macroprudential instruments. In this respect, much international work has focused on establishing the conceptual and empirical foundations for improving the design of instruments and enabling their use.

…which seek to prevent or mitigate systemic risks

In short, macroprudential instruments seek to prevent or mitigate systemic risks. That is to say, they seek to correct or discourage the excessive build-up of risks whose materialisation might affect the financial system as a whole. And, in turn, they seek to provide the authorities with the means to safeguard the system should such risks materialise. For example, the

primary aim of the countercyclical capital buffer introduced in Basel III is to afford protection against periods of excessive credit growth and, symmetrically, to avoid an excessive reduction in credit in recessionary periods.

CRD IV/CRR provide for a set of instruments…

In the European arena, the Capital Directive and Regulation (CRD IV/CRR) provide for a set of instruments of potential use in macroprudential policy, including the following:[2]

— Countercyclical capital buffer: this is a buffer of capital above microprudential minimum requirements. It focuses on cyclical risks at the aggregate level. Its level can vary from 0%-2.5% of risk-weighted assets, depending on an initial reference-based quantitative indictor (determined by the difference between the credit/GDP ratio and its trend), other potential quantitative indicators and qualitative data.

…including most notably countercyclical capital buffers, for global and domestic systemic banks, and against systemic risks. They all set additional capital surcharges in terms of risk-weighted assets

— Capital buffers for global and domestic systemic banks: as in the case of the countercyclical buffer, these are established as additional capital surcharges in terms of risk-weighted assets. They focus on structural risks originating in the "systemicity" of certain banks (risks to the financial system in the event of situations of stress or of the bankruptcy of these banks). In the case of global banks, assessment of their systemicity is based on quantitative indicators of their size, interconnectedness, substitutability, complexity and cross-border activity. The use of supervisory discretion is permitted in this assessment. The criteria for domestic systemic banks are more flexible, although they also draw on quantitative indicators in principle. Capital surcharges for global systemic banks vary from 1%-3%. For domestic systemic banks, surcharges are limited to 2%.

— Buffer against systemic risks: as with the countercyclical buffer, this is set as a percentage of risk-weighted assets. The focus is on long-term acyclic (or structural) risks. While there are certain restrictions to its scope and use (risks not covered by CRD IV/CRR must be covered and disproportionate adverse risks should not be introduced), it is not essentially prescriptive since specific criteria are not provided for as is the case with the buffers for systemic banks.

— Sectoral capital requirements: these include the possible setting of higher risk weightings for exposures between financial institutions and with the residential and commercial real estate sector, and of higher minimum values for loss given default (LGD) on exposures secured by real estate. The scope of these instruments is more localised compared with the aggregate capital instruments (countercyclical capital buffer).

There is also a possibility of using sectoral capital requirements, in respect of liquidity, that are applicable to large exposures and may be publicly disclosed

— Liquidity requirements: these include the possible setting of higher liquidity requirements in respect of microprudential minimums (e.g. the liquidity coverage ratio or the net stable funding ratio). These additional requirements may be variable over time.

— Requirements applicable to large exposures: this instrument encompasses the possible setting for macroprudential reasons of restrictions additional to microprudential ones in terms of concentration of exposures. The restrictions may be applied, for instance, to a specific sector or asset class.

— Macroprudential use of Pillar 2 (supervisory review): use would be analogous to the use of microprudential Pillar 2, but for a macroprudential purpose (it would encompass

2 Certain details of the instruments are under discussion at the European level and subject to possible revision.

systemic risks not covered by macroprudential instruments based on Pillar 1 requirements). The macroprudential use of Pillar 2 includes an extensive set of potential measures, including additional own funds requirements and limits on specific operations or business. Its implementation is based on the consideration of systemic risks by the competent authorities in their supervisory review and examination processes (SREP).

— Public disclosure requirements: this includes possible measures for increasing the frequency, content or form of the information presented by banks to the general public.

Under this list, the countercyclical buffers and those for global systemic banks are mandatorily applicable by the macroprudential authorities. The remaining instruments are optional. National legal frameworks may further include other types of instruments such as dynamic provisions, the leverage ratio and ceilings on loan-to-value (LTV) and loan-to-income (LTI) ratios.

Progress in setting in place the different instruments and making them operational has been mixed

While all the instruments in CRD IV/CCR are in principle available to the national macroprudential authorities, progress in making them operational and the administrative processes for their activation differ from instrument to instrument. The instruments envisaged under Basel III (the countercyclical capital buffer and the buffer for systemic banks) are those that are most advanced and whose activation and deactivation processes are clearest. At the other end of the scale are some of the instruments included under Art. 458 of CRD IV/CCR, such as the liquidity requirements.

The ESRB issued a recommendation in 2013 on intermediate macroprudential policy goals and instruments. The goals include dampening and avoiding the excessive growth of credit and leverage, as well as maturity mismatches and market illiquidity

The European Systemic Risk Board (ESRB) has worked intensely on contributing to the development of a macroprudential policy framework in Europe. To this end, the ESRB issued a recommendation in 2013 on intermediate macroprudential policy goals and instruments. This recommendation seeks to ground the ultimate goal of macroprudential policy in practice, and in this way make macroprudential policy more operational, transparent and accountable. The intermediate goals provide an economic basis for the selection of the various macroprudential instruments. The intermediate goals identified and some examples of instruments are as follows:

1. To dampen and avoid excessive growth of credit and leverage. Examples: the countercyclical capital buffer, sectoral capital requirements, macroprudential leverage requirements

2. To dampen and avoid excessive maturity mismatches and market illiquidity. Examples: macroprudential adjustments to the liquidity coverage ratio or to the net stable funding ratio, and loans/deposits ratios.

3. To limit direct and indirect risk concentration. Examples: restrictions on large exposures, requirements in respect of central counterparty clearing.

4. To limit the systemic effect of unsuitable incentives for reducing moral hazard. Examples: capital surcharges for global and domestic systemic banks.

5. To reinforce the resilience of financial infrastructures. Examples: initial margin requirements and haircuts on collateral in central counterparty clearing, and public disclosure requirements.

In addition, the ESRB has recently published a Manual for the use of macroprudential instruments in the banking sector along with a report on macroprudential policy

In addition, the ESRB has recently published a Manual for the use of macroprudential instruments in the banking sector along with a report on macroprudential policy. Both documents seek to offer assistance to European authorities in the implementation of the macroprudential instruments at their disposal and, thus, to make further headway in the treatment of systemic risks. As set out in the CRD IV/CRR, the ESRB is working on specific guidelines for the use of the countercyclical capital buffer in Europe.

3.3 The Single Resolution Mechanism (SRM) in Europe. Latest developments

On 20 March 2014 an agreement was reached on the Regulation for the SRM …

On 20 March 2014 an agreement was reached on the Regulation for the SRM which, along with the Single Supervisory Mechanism (SSM), is a key pillar of the Banking Union. The aim of this agreement is to provide for an orderly resolution, with uniform criteria, of all institutions subject to its scope, building consistently on the provisions contained in the forthcoming Bank Recovery and Resolution Directive (BRRD).

The approval of this agreement will be accompanied by the signing of an Intergovernmental Agreement, likewise agreed upon, which will develop specific aspects that, in light of their fiscal nature, may prove problematic in a Community regulation.

…which will comprise three fundamental bodies

To perform its functions, the SRM will have three fundamental bodies: a Single Resolution Board (SRB), a Single Resolution Fund (SRF) and a system of National Resolution Authorities (NRAs).

The SRB will, in turn, act through two compositions, namely plenary and executive, and will submit its decisions to the control of the European Commission or Council, as appropriate, observing the usual principles of transparency and accountability. The plenary session will concern itself with general decisions or those involving a significant use of SRF resources; the more restricted composition of the executive session, meanwhile, will confine itself to decisions relating to a specific banking group.

The regulation is applicable to the institutions of all euro area members and to those other States that voluntarily wish to participate through a cooperative agreement with the SSM.

A two-step system is established whereby the institution supervised directly by the SSM will be under the direct stewardship of the SRB

As with the SSM, a two-step operating system is established whereby institutions supervised directly by the SSM will remain under the direct stewardship of the SRB; those which engage in cross-border activity and also those whose participating Member States so request it. The NRAs, in addition to supporting the SRB in the foregoing tasks, are entrusted with monitoring the remaining institutions, unless the institution involved is in the process of being resolved and it is necessary to use SRF resources. To ensure uniformity in the criteria applied, the SRB reserves itself the right to proceed with and exercise the power to take decisions that correspond in principle to the NRAs.

The SRF shall be set up with contributions by banks that will reach an amount of €55 billion in 2023

The Single Resolution Fund shall be set up with contributions by banks that will rise to an estimated amount of €55 billion in a period running to 2023. These contributions will be made having regard to criteria based on the size and risk of the institutions relative to all those participating under the above-mentioned scope of application.

From the outset, there will be significant pooling of resources…

Initially, these contributions will bolster national sub-baskets, although from the outset they will all share a sizeable portion of the cost that may arise from a hypothetical resolution. The proportion of shared costs will grow until reaching 100% in 2023, and there will from the outset be a significant pooling of resources. Thus, for example, such pooling will already have amounted by 2017 to 60% of all available resources.

…which, moreover, will progressively reduce the weight of the national component

Accordingly, although the way in which this distribution of expenses among national sub-baskets is specified is complex, it meets the following criteria: (i) swift mutualisation of contributions; and (ii) burden-sharing among jurisdictions affected by international groups. What is ultimately involved here is to reduce the weight of the national component as the single area in respect of supervisory and resolution competencies becomes entrenched.

The entry into force of the Mechanism is envisaged for 1 January 2015, although the setting up of the SRF and the attendant resolution powers will not begin until 2016, with the BRRD being applied until then by the NRAs. Additionally, as part of the package, it has been agreed to bring forward the entry into force of the bail-in rules established in the Resolution Directive from 2018 to 1 January 2016.

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