

THE RECOVERY OF THE SPANISH ECONOMY AND RECENT DEVELOPMENTS OF THE BANKING SYSTEM

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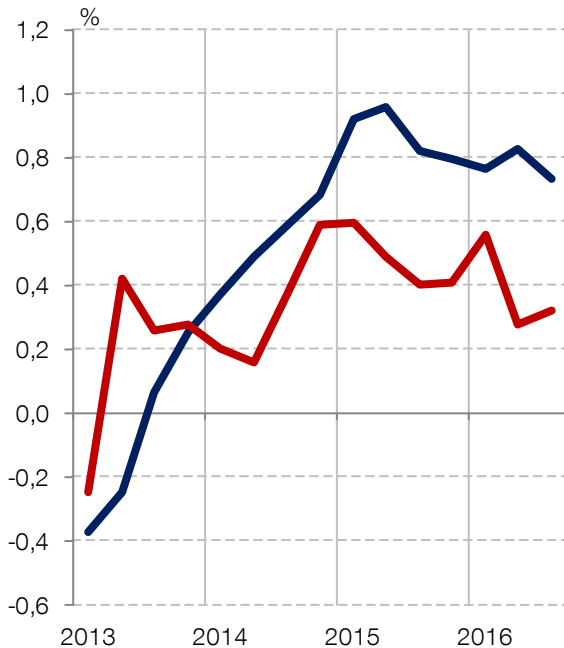
- 1** The recovery of the Spanish economy and its drivers
- 2** The banking sector
 - 2.1 Challenges
 - 2.2 Possible responses

1. A SUSTAINED RECOVERY

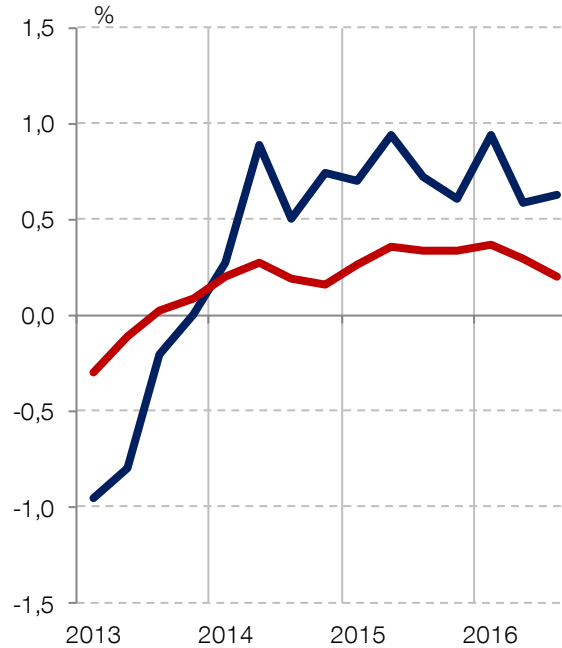


- The Spanish economy has completed **three years of sustained expansion**, with growth in activity and employment above that of its euro area partners.
- **Price** increases have been more moderate than in the whole euro area, allowing for **sizeable competitiveness (re)gains**.

GDP
(q-o-q growth rate)



EMPLOYMENT
(q-o-q growth rate)



Headline inflation rate (HICP)
(y-o-y growth rate)



SOURCES: INE and Eurostat.

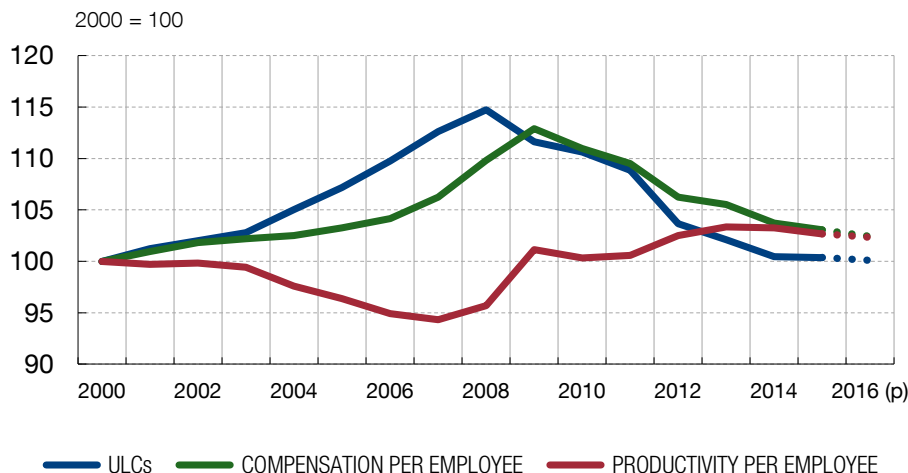
— SPAIN — EURO AREA

1. STRUCTURAL FACTORS BEHIND THE RECOVERY: COMPETITIVENESS GAINS IN LABOUR AND FINANCIAL COSTS...

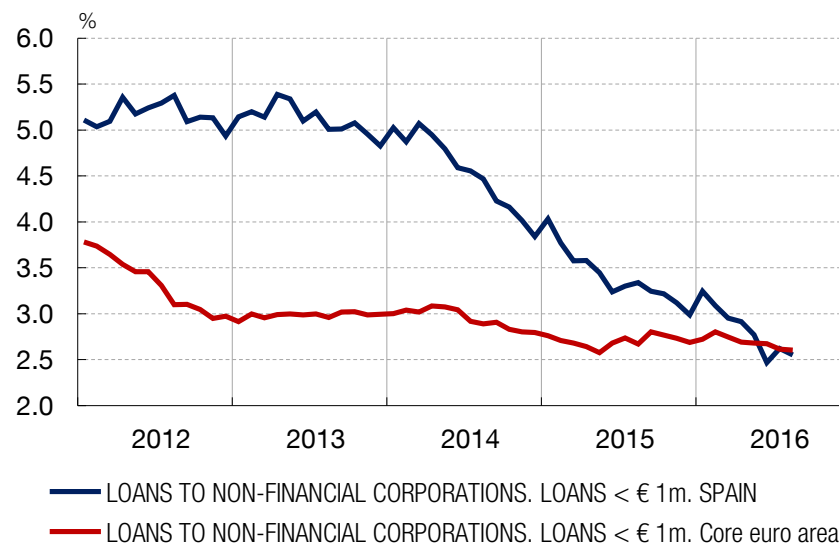


- On top of some **temporary** elements, the recovery is explained by several factors of a more **permanent** nature.
- Particularly relevant is the **improvement in competitiveness**, both in terms of relative labour costs and in terms of relative financing conditions.

UNIT LABOUR COSTS IN SPAIN RELATIVE TO THE EURO AREA



LENDING RATES. NON-FINANCIAL CORPORATIONS



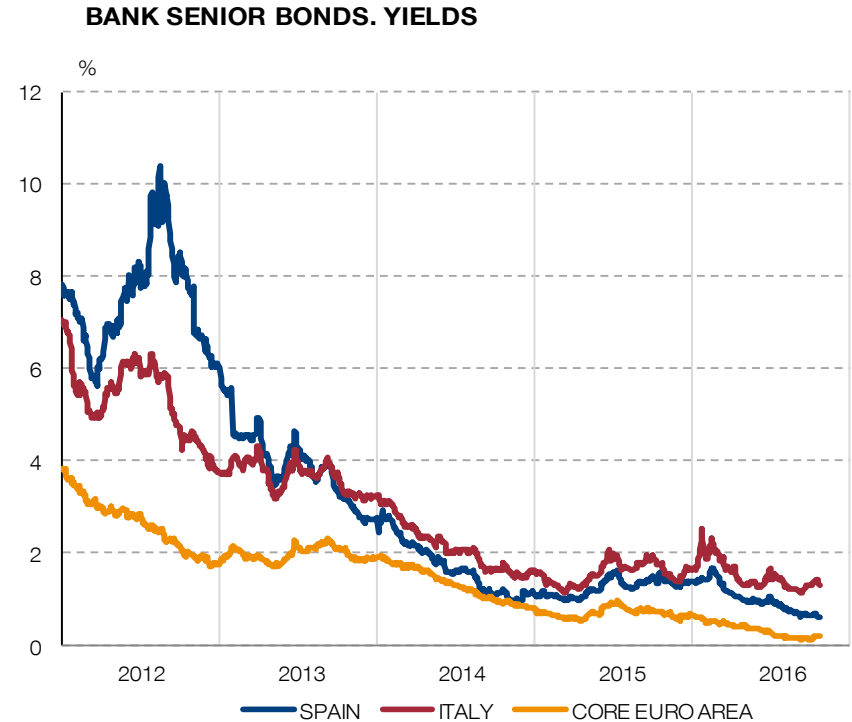
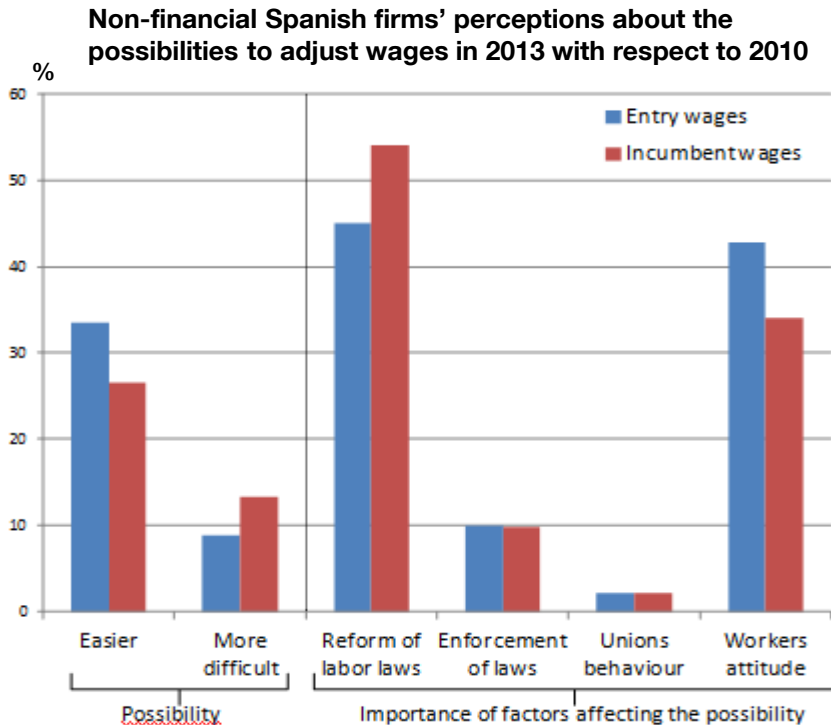
SOURCES: INE, Eurostat, ECB and Banco de España.

(p) Projections of BdE and ECB.

...THAT ARE LARGELY ATTRIBUTABLE TO RECENT REFORMS IN THE LABOUR MARKET AND THE FINANCIAL SECTOR



- **The 2012 labour market reform** opened new venues of internal flexibility for firms, favouring wage moderation and supporting the recovery of employment.
- **The 2012-2013 financial sector reform** (balance-sheet cleaning, recapitalisation, restructuring) contributed to a significant reduction in the banks' cost of funding, that they passed-through to lending rates.

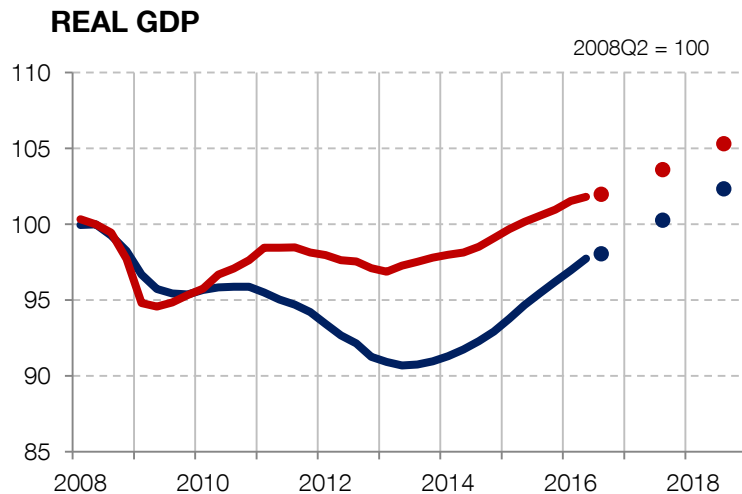


1. THE OUTLOOK



- The expansionary phase will extend into the medium term albeit at a somewhat **lower pace**.
- **Growth** will continue to be **employment-intensive** and **job creation** will provide for further reductions in the **unemployment rate**.
- **GDP level pre-crisis** will be achieved along 2017, but the **fall in employment** will be **more persistent**.

	Projections (September 2016)			
	2015	2016	2017	2018
GDP	3.2	3.2	2.3	2.1
Employment	3.0	2.9	2.0	1.8
Inflation (CPI)	-0.5	-0.3	1.5	1.6



SOURCES: Eurostat, ECB, INE and Banco de España.

1. RISKS TO THE BASELINE AND CHALLENGES



Risks surrounding GDP projections: **tilted to the downside**

- *External risks: associated with global developments: some emerging markets, worldwide political tensions, uncertainty over the UK's exit from the EU.*
- *Internal risks: uncertainty over the future course of economic policies in relation both to the process of fiscal consolidation and to economic reforms.*

Despite the progress made in the correction of imbalances, significant challenges remain in place:

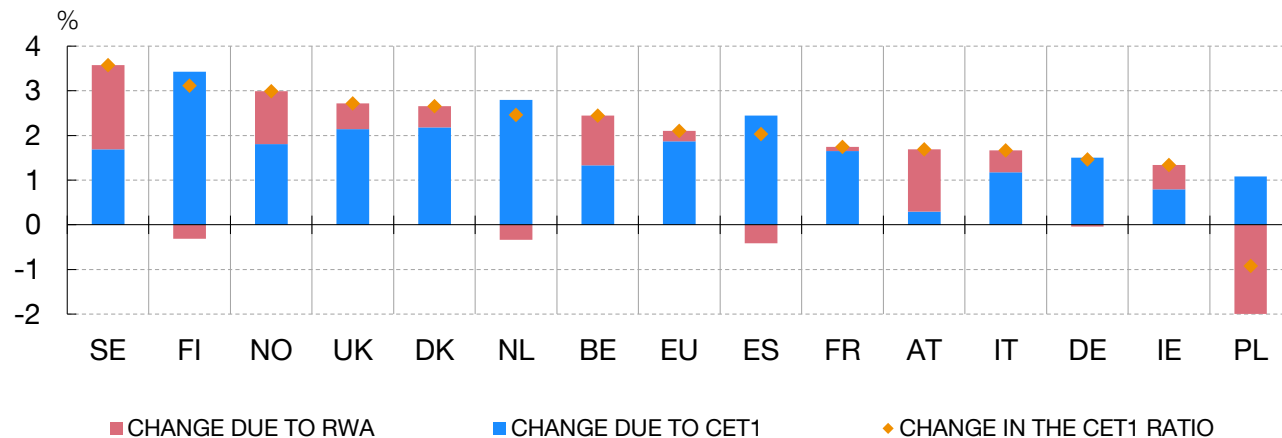
- *Reducing still very high unemployment to acceptable levels*
- *Resuming fiscal consolidation*
- *Improving productivity growth*
- *Reducing the relatively high needs of external financing*

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2. BANKING SECTOR: WHERE DO WE STAND?

- Efforts from regulators, supervisors and banks have materialised in an **improvement in capital positions**: CET1 ratios have increased in practically all European countries.
- **Spanish banks** show an increase similar to the EU average. In this case, the evolution of RWA has not contributed to the increase.
- In addition, in Spain, there has been a big effort in **balance sheet clean-up** (provisions) of approximately 300,000 mill.€ since 2008.

PERCENTAGE POINTS CHANGE IN CET1 RATIO BETWEEN DECEMBER 2013 AND DECEMBER 2015 (a)



SOURCE: European Banking Authority.

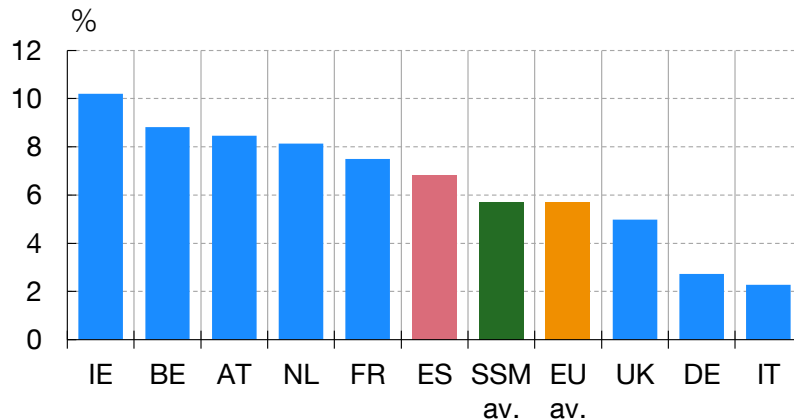
a The comparison is made for institutions that participated in the 2016 ST (except from Hungary), taking the data for these same institutions in the 2014 ST, and clustering by country. The orange diamond shows, for each country, the total change in the CET1 ratio from December 2013 to December 2015. The blue and dark red bars show the portion of this change attributable to changes in CET1 capital and in RWAs, respectively. Positive bars denote an inter-period increase in CET1 capital and an inter-period reduction in RWAs, changes that would result in an increase in the CET1 ratio.

2.1 CHALLENGES - PROFITABILITY



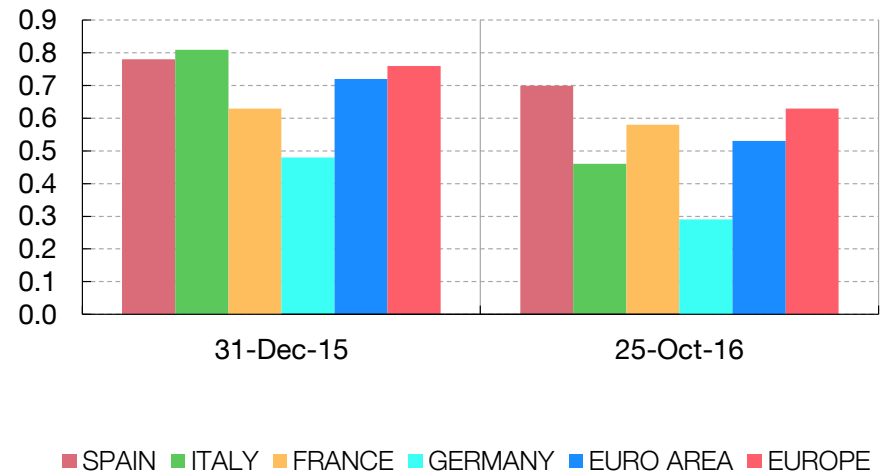
- **ROE for Spanish banks** of 6,8%, slightly above the SSM average.
- Low interest rates, uncertain macroeconomic developments and high NPL levels weigh down on it and, in turn, on investors expectations (reductions of the price-to-book value ratios).
- Although clearly below 1, Spain continues having a relatively better **price-to-book ratio** than European peers.

ROE. EUROPEAN COMPARISON. JUNE 2016



SOURCE: European Banking Authority.
Risk Dashboard June 2016 (198 entities)

PRICE-TO-BOOK-VALUE RATIO OF THE BANKING SECTOR



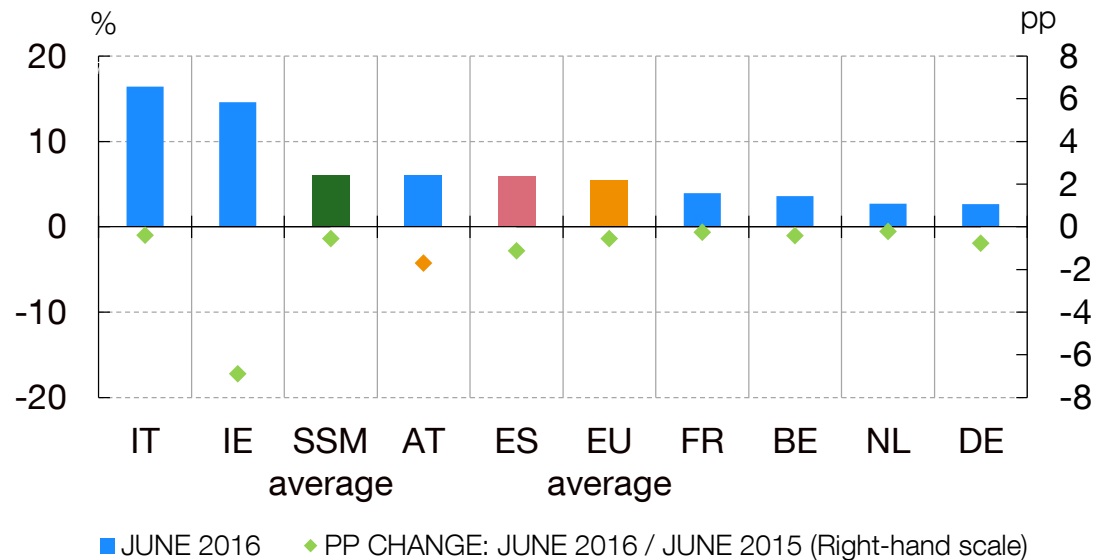
SOURCE: Datastream.

2.1 CHALLENGES - NPL



- **NPLs** are still high... but decreasing (at a pace of approximately 9% in the euro area and 18% in Spain, y-o-y rates)

EU NPL RATIOS. June 2016



SOURCE: European Banking Authority
Risk Dashboard June 2016 (198 entities).

2.1 CHALLENGES - REGULATION

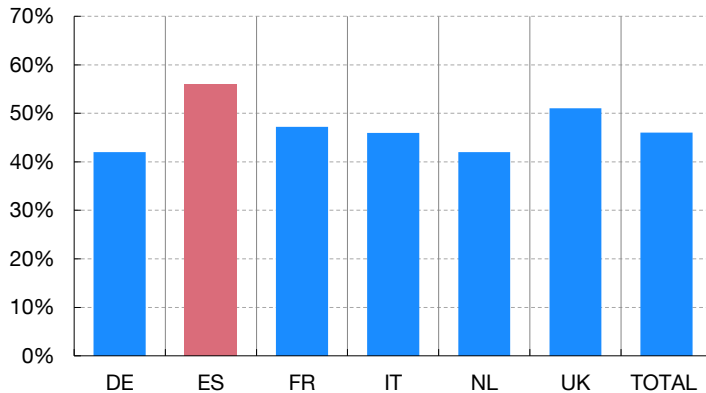


Regulation

i) **BCBS agenda:** the challenge of improving risk measurement without significantly increasing capital requirements.

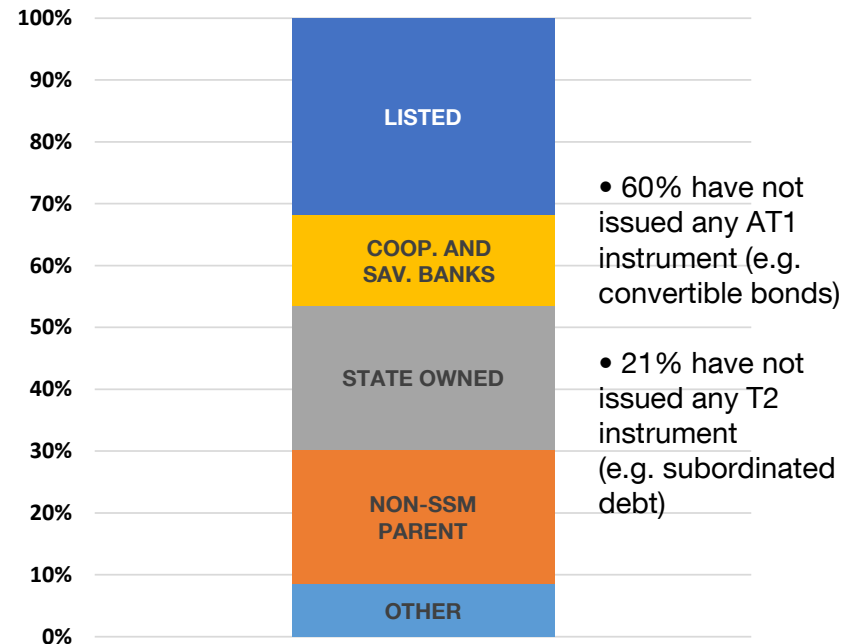
ii) **MREL:** it is likely to be a binding restriction for non-listed medium size banks.

CORPORATE PORTFOLIO SUBJECT TO IRB. RWA DENSITY
December 2015



SOURCE: EBA, Stress Test 2016 (51 entities).

SSM SIGNIFICANT INSTITUTIONS
BY OWNERSHIP STRUCTURE (JUNE 2016)



SOURCE: Banco de España

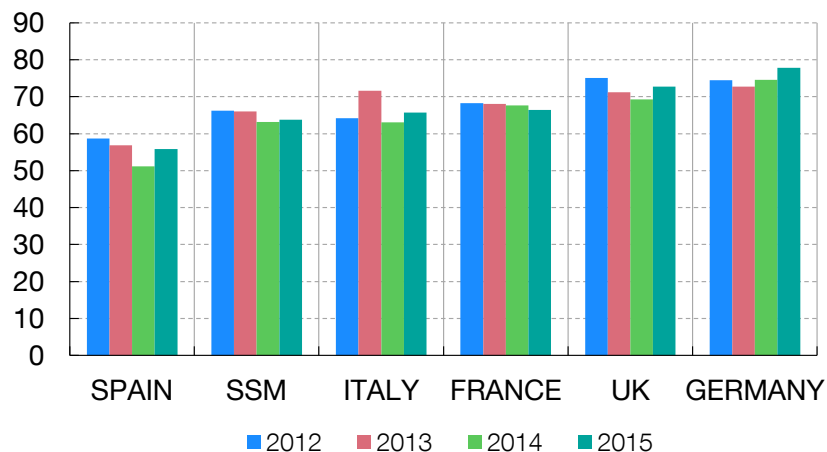
2.2 POSSIBLE RESPONSES: EFFICIENCY



- Cost-to-income ratios have been relatively stable over the last years. **There appears to be room for improvement.**

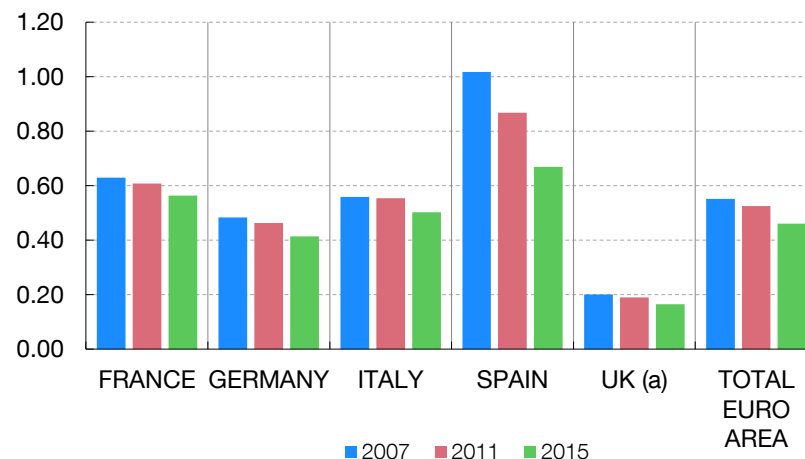
- **New technological developments** should allow further gains in efficiency. Proximity to customers is less dependent on face-to-face contact.

COST-TO-INCOME



SOURCE: SNL. Significant institutions on which data are available each year; in the case of UK, the 5 biggest banks, in terms of total assets.

NUMBER OF OFFICES PER ONE THOUSAND INHABITANTS

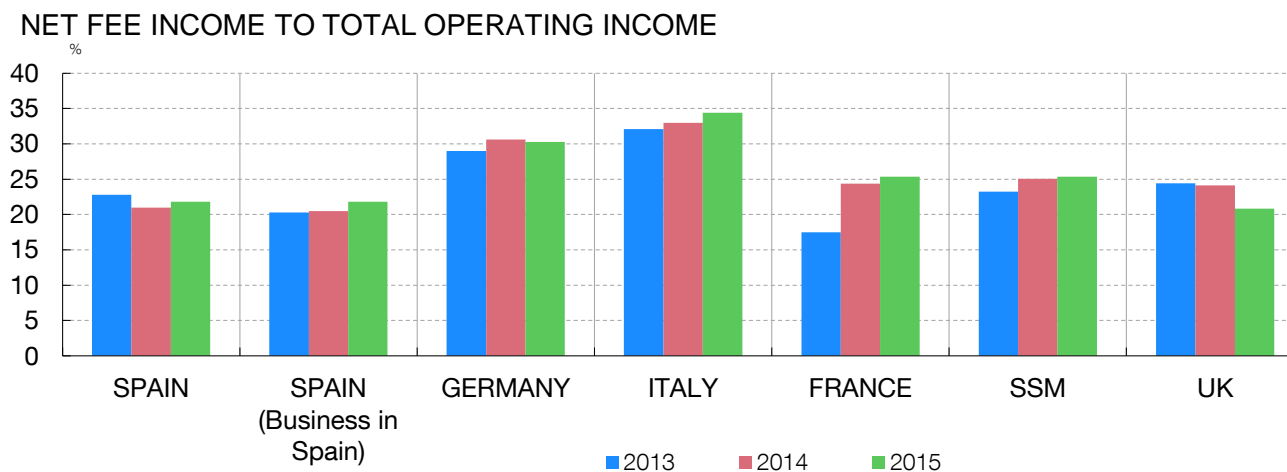


SOURCE: ECB (Structural Indicators), World Bank and Eurostat. a Data refer to 2014.

2.2 POSSIBLE RESPONSES: NEW PRODUCTS AND SERVICES



- Room to improve **fee income**.
- **Fintech** is a challenge but also an opportunity for banks.



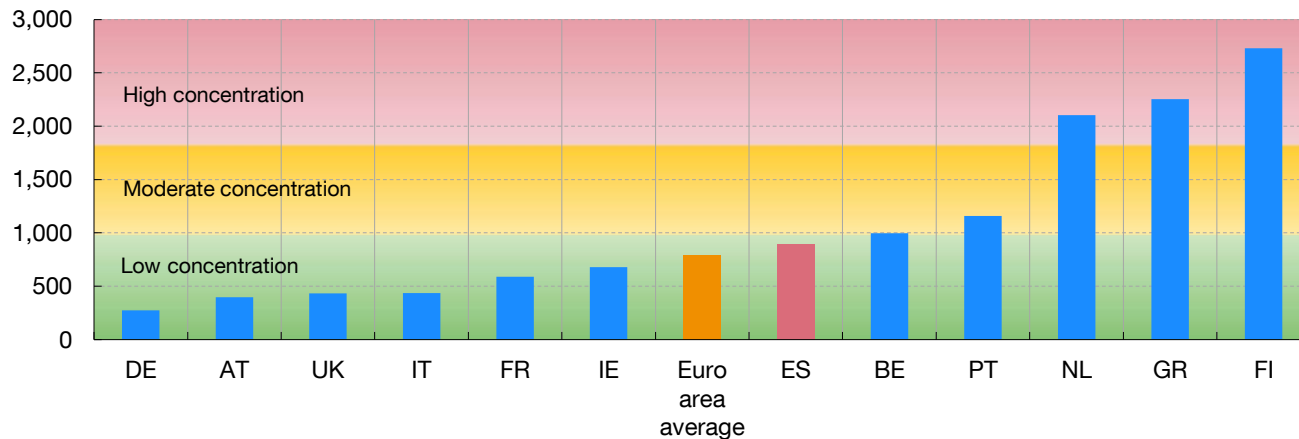
SOURCES: SNL (significant institutions on which data are available each year; in the case of UK, the 5 biggest entities, in terms of total assets) and Banco de España.

2.2 POSSIBLE RESPONSES: CONSOLIDATION



- The need to continue reducing costs will encourage **mergers and acquisitions** within each country.
- In accordance with the HHI index, **there seems to be room for consolidation** in the largest European countries.
- In any case, what is desirable is to have **cross-border mergers** and **truly pan-European banks**.

HERFINDAHL-HIRSCHMAN INDEX
December 2015



SOURCE: ECB (*Structural Indicators*)

The euro area average is calculated as the average of the Herfindahl-Hirschman indices of each of the euro area countries, weighted by their total assets