

ANNUAL REPORT 2017

CHAPTER 2

THE CHALLENGES FACING THE BANKING SECTOR



THE SOLVENCY AND PROFITABILITY OF THE SPANISH BANKING SYSTEM HAVE IMPROVED IN RECENT YEARS

favoured by:

1. The clean-up and restructuring following the crisis

2. The economic recovery

DESPITE THIS IMPROVEMENT, SIGNIFICANT CHALLENGES REMAIN

CHALLENGES REMAINING

Reduction of assets impaired by the crisis

Return to profitability

Adjustment to the new regulatory framework

Addressing the new competition framework

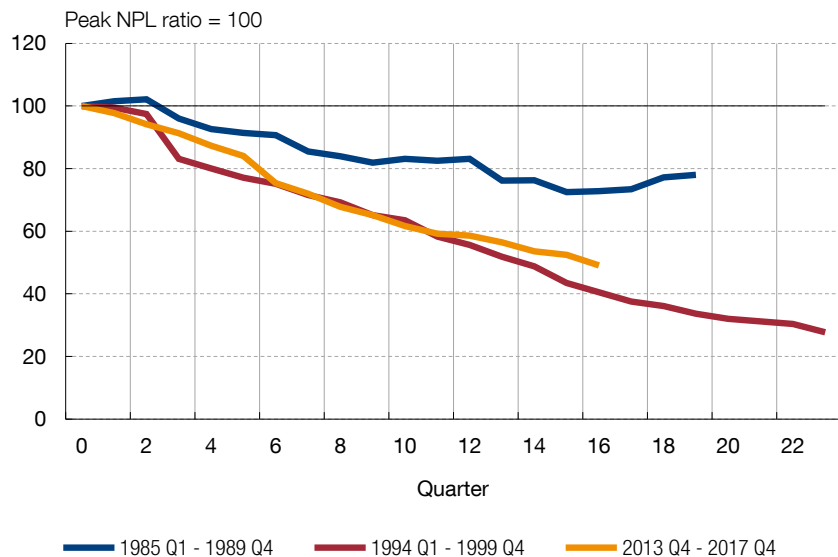
THE LEGACY OF THE CRISIS (1)



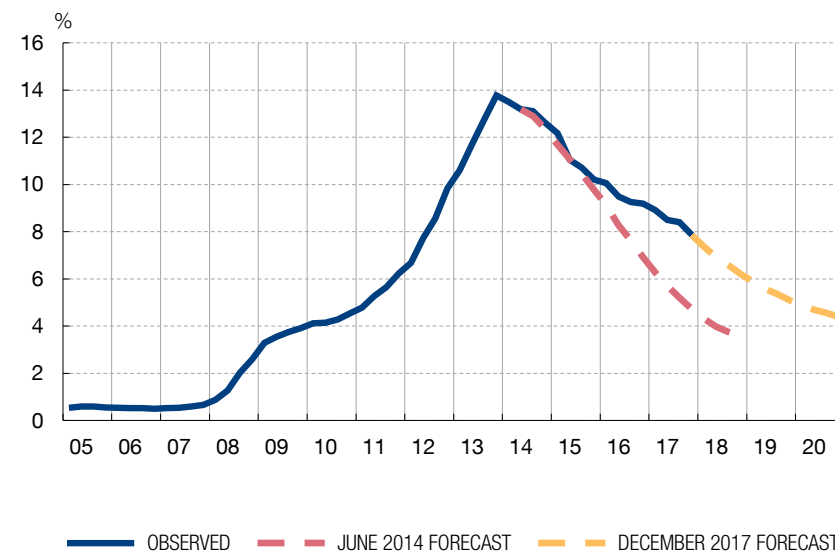
Non-performing loans have been reduced in Spain by 50% since their peak, but remain high. The decrease in foreclosed assets has been more limited, although a significant adjustment is anticipated in 2018.

Looking forward, the non-performing loans ratio will foreseeably trend downward under the influence of the economic growth, although at the end of 2020 this ratio may still be above pre-crisis levels.

VOLUME OF NON-PERFORMING LOANS



PROJECTED NPL-TO-LOANS RATIO



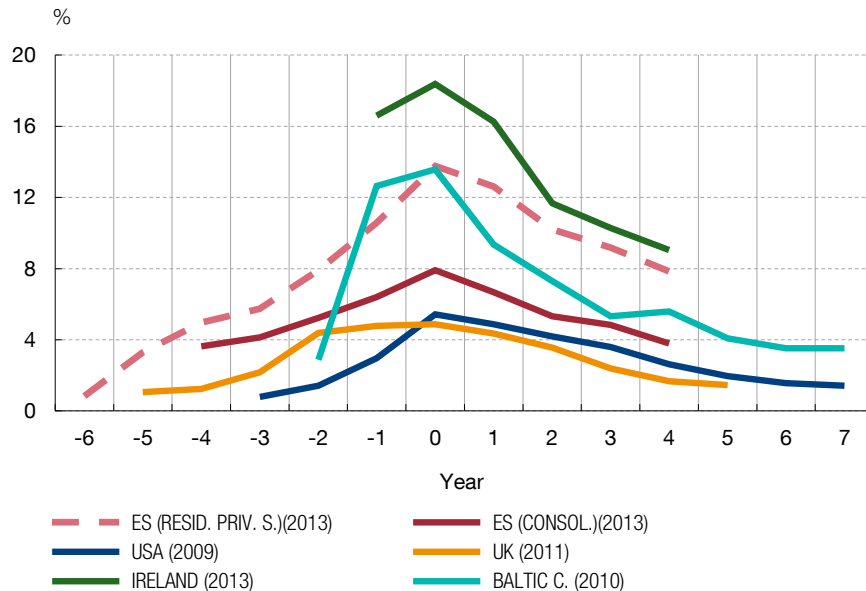
THE LEGACY OF THE CRISIS (2)



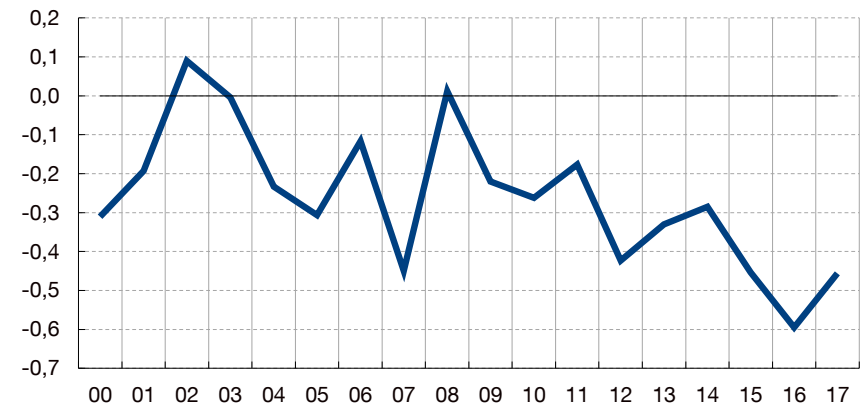
The international evidence shows that increases in the volume of non-performing loans tend to take a long time to be corrected.

In any event, the persistence of high non-performing loans ratios has an adverse effect on banks themselves and on the economy, so special surveillance by the authorities is warranted.

INTERNATIONAL COMPARISON OF NPL RATIOS



CORRELATION BETWEEN THE YEAR-ON-YEAR CHANGE IN CREDIT EACH YEAR AND THE NPL RATIO A YEAR EARLIER



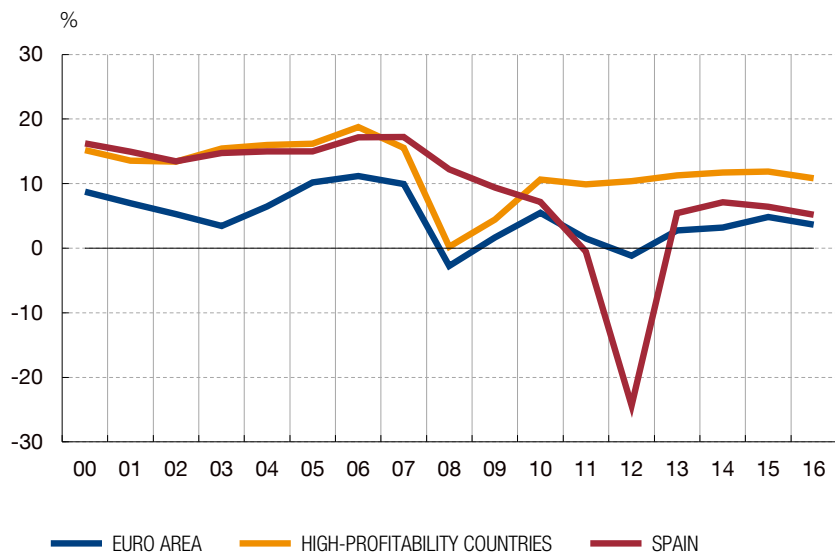
THE RETURN TO PROFITABILITY. WHERE IS THE PROBLEM?



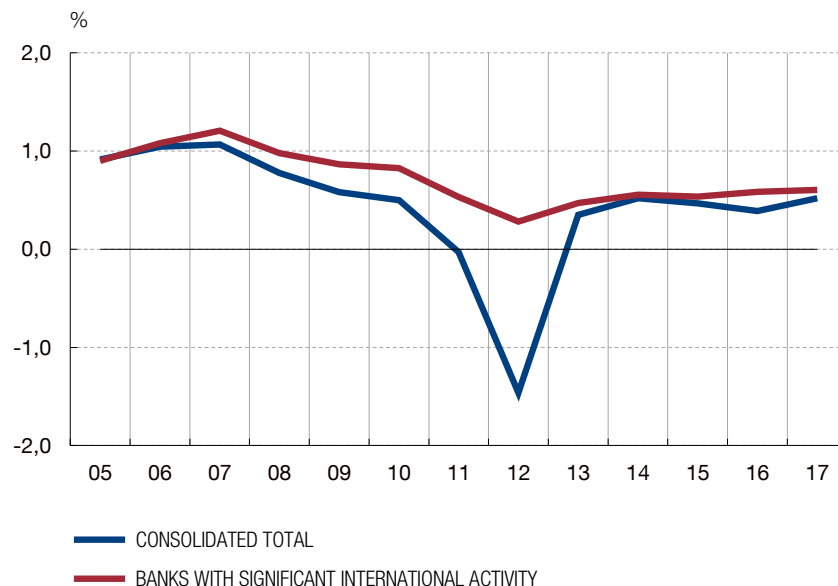
The profitability of Spanish banks has returned to positive territory and stands above the euro area average, although below the levels before the crisis and in some developed economies. The main differences with respect to these economies lie in the recent behaviour of impairment losses and operating expenses as a percentage of assets in Spain.

The low profitability is concentrated in business in Spain.

RETURN ON EQUITY (ROE)



RETURN ON EQUITY (ROE)

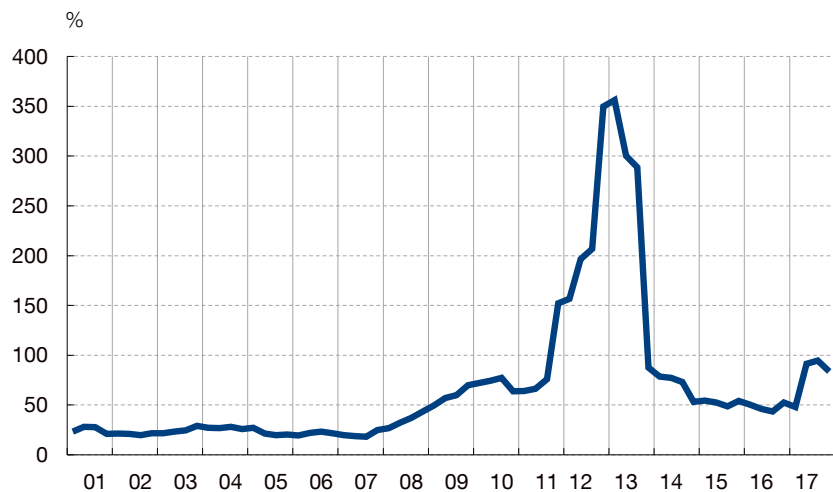


THE RETURN TO PROFITABILITY. EXTRAORDINARY LOSSES

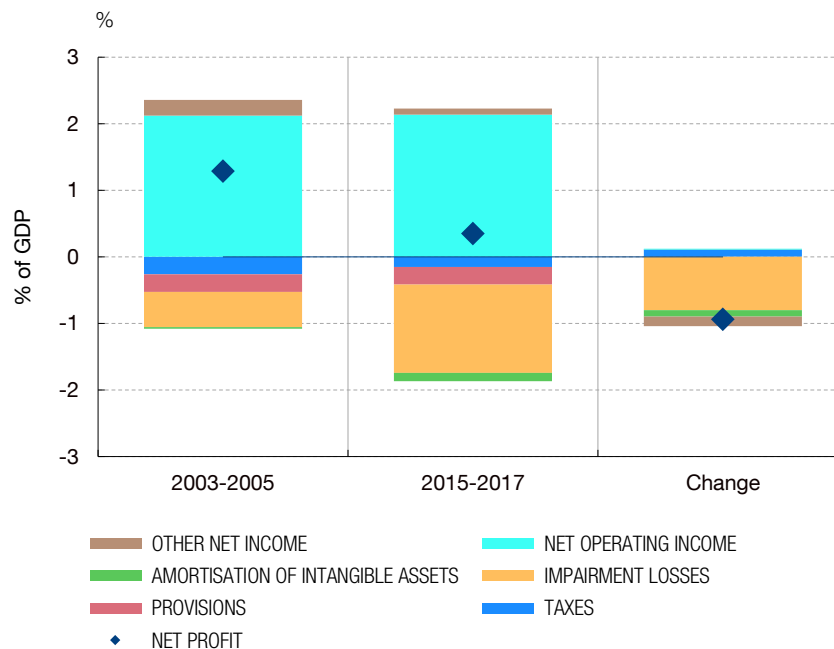


Impairment losses and, to a lesser extent, other extraordinary losses again ate up a significant portion of the operating income of Spanish banks in 2017 and remain above pre-crisis levels, accounting for the bulk of the fall in net profit as a percentage of GDP.

IMPAIRMENT LOSSES AS A PERCENTAGE OF NET OPERATING INCOME



INCOME STATEMENT BREAKDOWN



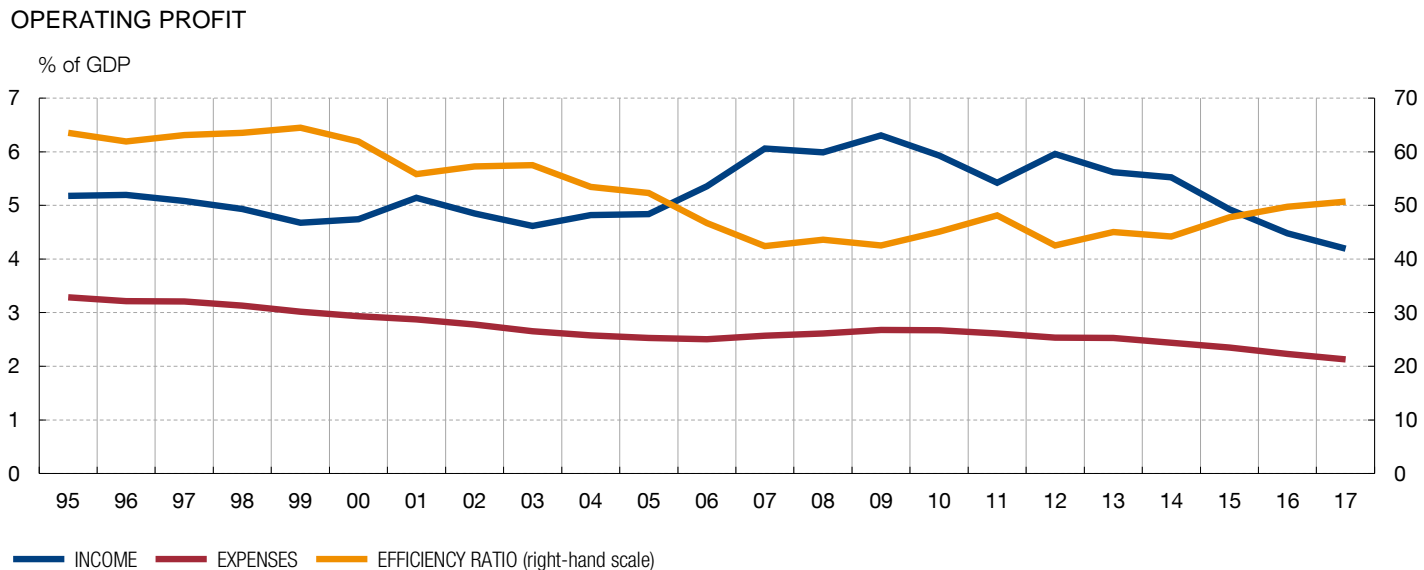
THE RETURN TO PROFITABILITY. ADJUSTMENT OF CAPACITY



The economic upturn at the beginning of the century was accompanied by a sharp rise in bank assets and income, which clearly outstripped the increase in expenses and brought improvements in efficiency.

The onset of the crisis unleashed a reverse process of correction of the previous excesses, in which income fell by more than expenses.

In the short- and medium-term, the high levels of bank lending seen in the previous expansion are not expected to return, so banks will have to keep adjusting expenses.



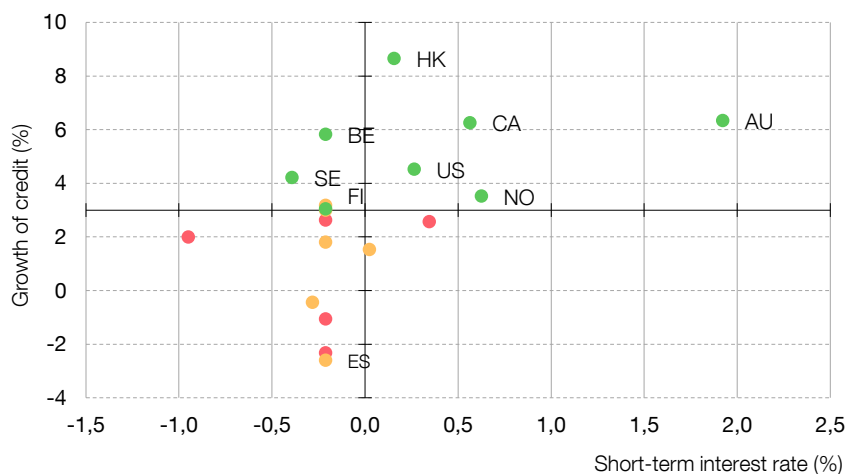
THE RETURN TO PROFITABILITY. LOW INTEREST RATES



Low interest rates reflect a specific macroeconomic environment and have opposing effects on bank profitability. The available evidence on their net effect is not conclusive.

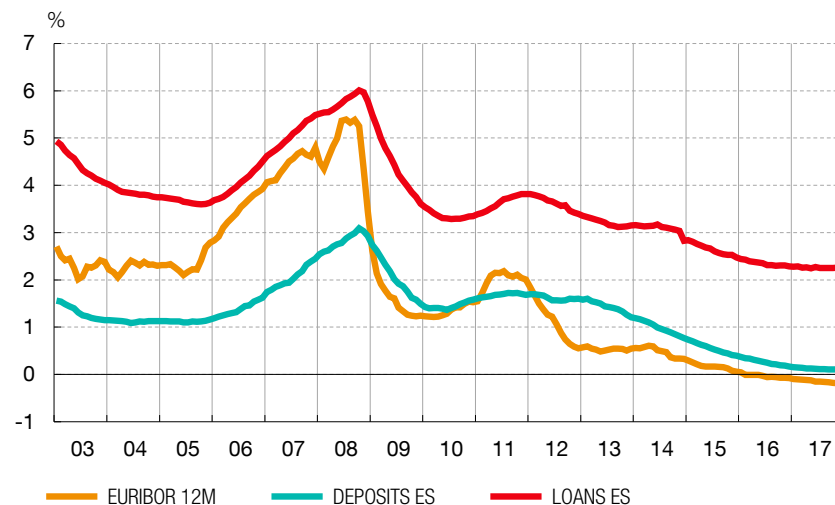
Their impact on net interest income is negative due to the floor effect of zero rates. However, given the low price elasticity of the demand for credit, banks have cushioned this effect by raising loan interest rates.

INTEREST RATES, CREDIT AND BANK PROFITABILITY (a)



a. 2015-2016 data. Red indicates a ROE below 4%, yellow between 4% and 9% and green above 9%.

INTEREST RATES ON OUTSTANDING BALANCES AND MARKET RATE



THE NEW REGULATORY FRAMEWORK

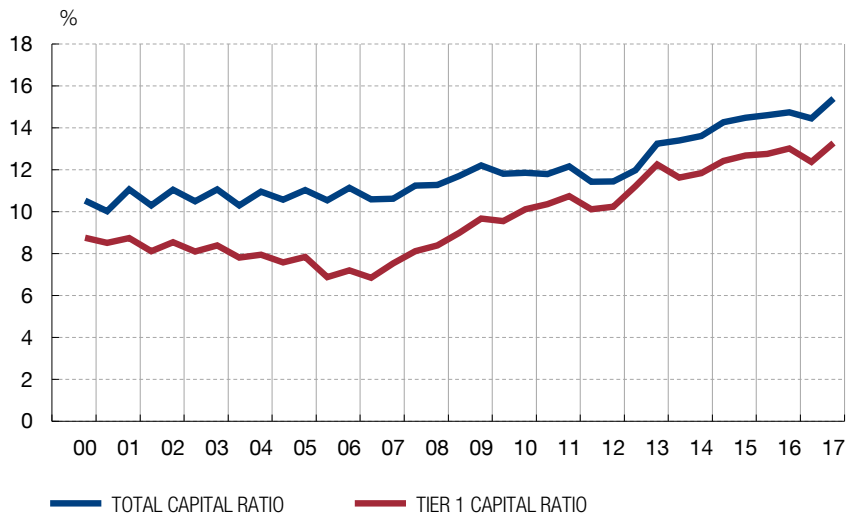


The new regulatory framework following the crisis is characterised by stricter capital and liquidity requirements and by additional resolution requirements.

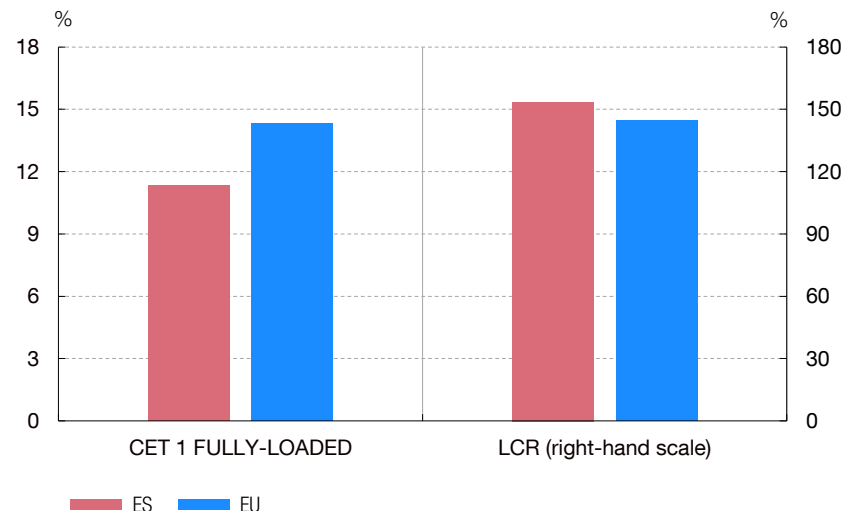
Following their recent headway, Spanish banks now stand around the euro area average in terms of liquidity and somewhat below it in terms of CET1 capital.

Many of the changes have already taken place, but significant tasks, such as the Basel III reform, MREL requirements or IFRS 9, still remain.

REGULATORY CAPITAL RATIOS



SPAIN-EU COMPARISON



THE NEW COMPETITION FRAMEWORK. NEW TECHNOLOGIES

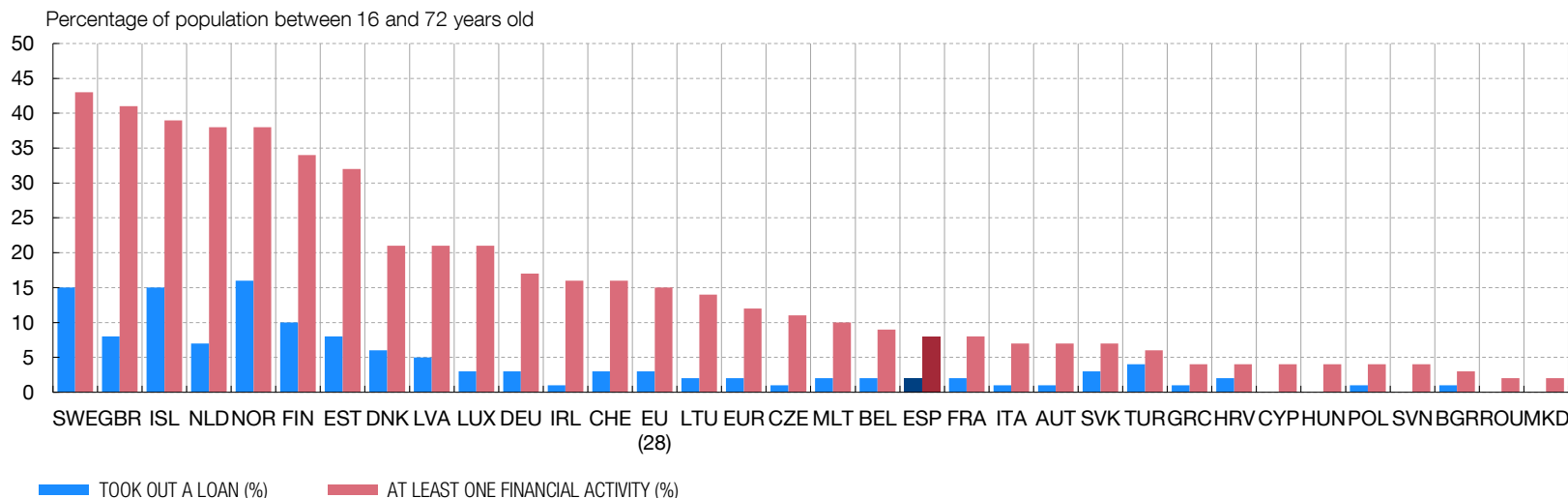


New technologies are characterised by their capacity to rapidly alter the competition framework (disruption). The response by banks entails short-term costs which are more difficult to face in the current environment of low profitability.

Despite the high degree of uncertainty, this is probably the most important challenge (and opportunity) for deposit-taking institutions at medium and long term.

Given its scant current penetration and the importance of physical marketing channels, there is ample room for the expansion of digital banking in Spain.

POPULATION USING THE INTERNET TO CARRY OUT FINANCIAL TRANSACTIONS IN 2017



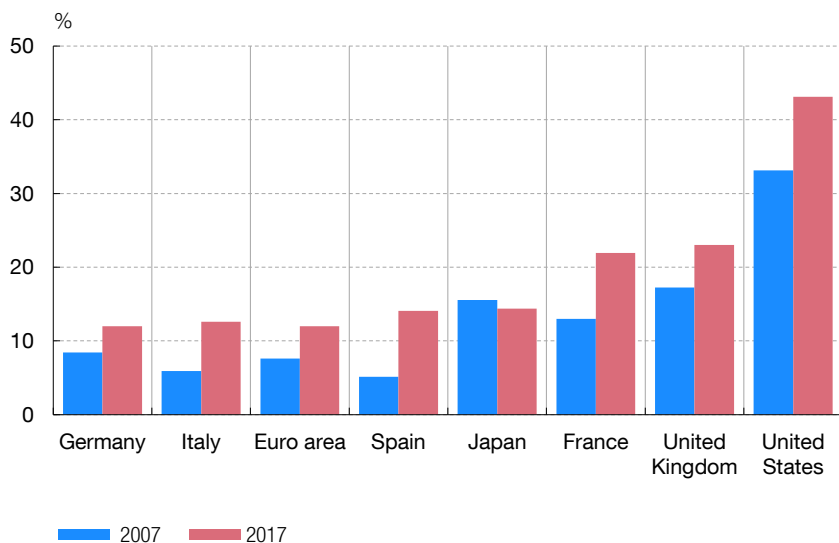
THE NEW COMPETITION FRAMEWORK. DISINTERMEDIATION



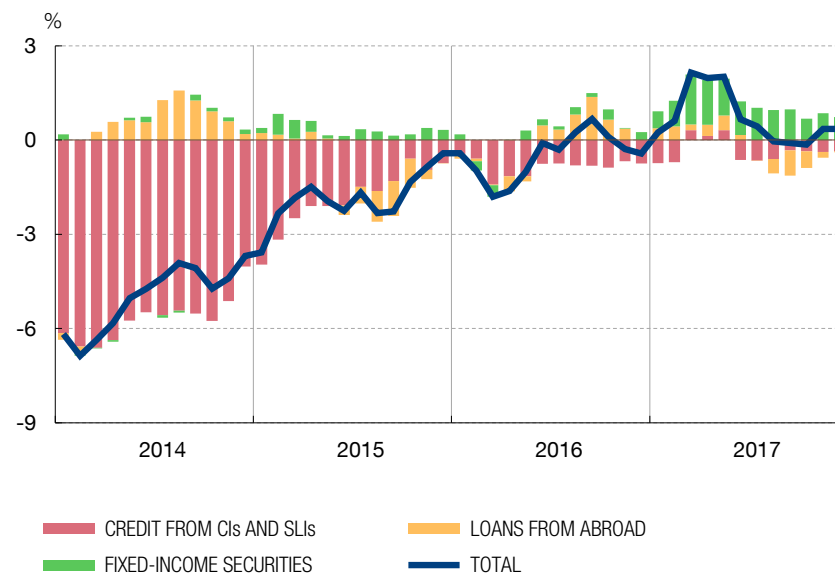
Spain's traditional funding structure, strongly intermediated by banks, has started to change slightly since the onset of the crisis.

In addition to the crisis, other conjunctural factors (such as the Eurosystem's asset purchase programme or the low interest rate policy) and structural factors (tighter regulation, new technologies, the capital markets union initiative) appear to be contributing to greater disintermediation in Spain.

PROPORTION OF FIXED INCOME IN THE TOTAL DEBT OF NON-FINANCIAL CORPORATIONS



CONTRIBUTIONS TO YEAR-ON-YEAR GROWTH OF THE FINANCING RECEIVED BY NON-FINANCIAL CORPORATIONS IN SPAIN





CHALLENGES REMAINING

Reduction of crisis-related impaired assets

- Non-performance remains high, with negative consequences for banks and economic activity
- Foreseeable scenario of continued declines in the coming years
- The current pace of decline requires ongoing monitoring of this risk

Return to profitability

- Current low profitability of business in Spain
- Main factors:
- Impairment losses and other extraordinary losses remain high
 - Insufficient adjustment of operating expenses in the face of the fall in the (unsustainably) low levels of income
 - Low interest rates exert pressure on net interest income, but their overall net effect is comparatively lower

Adaptation to the new regulatory framework

- In-depth reform of the regulatory framework
- Spanish banks have now largely adapted through higher levels of capital (below the European average) and liquidity (similar to the European average)
- Pending adjustments (Basel III reform, MREL, IFRS 9, PSD 2)

Addressing the new competition environment

- The new technologies bring challenges and opportunities. Increased competition and changes in the demand for banking services and in the means used to provide them
- Financial disintermediation risk: conjunctural factors (crisis, highly expansionary monetary policy) and structural factors (high bank dependence, new technologies)