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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	Europena Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
EPA	Official Spanish Labour Force Survey
ESFS	European System of Financial Supervisors
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
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
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
OTC	Over the counter
PD	Probability of default
PER	Price earnings ratio
pp	Percentage points
ROA	Return on assets
ROE	Return on equity

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

RWA	Risk-weighted assets
SCIs	Specialised credit institutions
SMEs	Small and medium-sized enterprises
SIV	Structured investment vehicle
SPV	Special purpose vehicle
TA	Total assets
TARP	Troubled Asset Relief Program
VaR	Value at risk
WTO	World Trade Organisation

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From mid-2011 to November, tensions on euro area financial markets increased significantly. Accounting for these adverse developments was the interaction of the worsening and spreading of the sovereign debt crisis, the persistence of doubts over the situation of the European banking sector and the deteriorating macroeconomic context. Compounding this were the uncertainties associated with Greece's situation and the possibility that a second bail-out programme could not be put together.

From December 2011 to March 2012 the tensions on financial markets eased. Contributing to this were the measures deployed in various areas. At the European level, at the Summit of Heads of State or Government on 9 December 2011, the foundations were laid for a new fiscal discipline and stability pact, and, at the same time, the legal framework to underpin the European Stability Mechanism was approved. Also in early December 2011, the European Central Bank (ECB) took a series of measures that contributed to easing tensions on financial markets, including most notably the provision of liquidity with full allotment at a fixed rate and at a term of three years in two auctions, the latter in late February 2012. Further, the activation of the second bail-out programme for Greece was a positive factor.

At the level of the Member States, too, measures were adopted in several spheres. In Spain, for example, notable fiscal measures were taken (including a reform of the Constitution so that all tiers of government should adhere to the principle of budgetary stability), a labour market reform was approved and the ongoing restructuring of the banking sector was furthered. In this latter instance, the measures introduced by Royal Decree-Law 2/2012 involve additional write-downs of the banking sector's exposure to construction and real estate development assets, thereby raising their coverage levels with provisions and capital. This is the case, in particular, for those assets related to land and developments under construction, as their value was subject to greater levels of uncertainty as a result of the process of adjustment in the real estate sector. On 17 April the Banco de España approved the plans submitted by credit institutions to comply with the above-mentioned Royal Decree-Law.

Since late March 2012, tensions have rebounded on financial markets, compounded by an adverse macroeconomic environment. It is against this background that Spanish deposit institutions have been pursuing their activity.

In these circumstances, credit to the private sector in Spain remained on a declining trend, which is largely due to the natural process of deleveraging by households and firms following the strong credit growth in the years prior to the crisis. Moreover, the course of credit can be explained by supply-side factors, due both to deposit institutions' difficulties in obtaining funding on international financial markets and to macroeconomic developments that impair borrowers' creditworthiness. Finally, the current economic juncture also limits the demand for funding by households and firms.

The weak economic circumstances help explain the fact that doubtful assets are growing, and that they will foreseeably continue to do so in a setting such as that described. However, the contribution of the construction and real estate development sector to the increase in doubtful assets remains to the fore, with that of the other sectors so far proving appreciably more moderate.

As to the construction and real estate development sector, the February 2012 measures to bolster the Spanish banking sector will lead to coverage ratios with provisions of 60% for land-related assets, to which a further 20 pp will need to be added for additional capital requirements. For real estate under development, these percentages, considering the greater provisions and the capital surcharge required, will rise to 65%. That entails protection for institutions against falls in land prices of the order of 87%, of 82% for developments under construction, and of 56% for finished housing.

The easing of tensions on euro area financial markets from December 2011 to March 2012 provided a window of opportunity. As has been the case throughout this crisis when such opportunities have arisen in the market, various Spanish institutions took advantage and issued debt on wholesale markets. This easing in tension between December and March, and especially the laxer liquidity tensions arising from the provision of funding by the ECB, have not translated into a relaxing of Spanish institutions' stance, and greater provisions and capital have indeed been required of them.

Retail deposits, following a continuous period of increases, have moved on a declining path in recent months, related essentially to the adverse macroeconomic setting (which has translated into a decline in saving and private-sector investment in financial assets) and to tougher competition with other saving products, non-bank (such as Treasury bills, the returns on which reached very high levels in late 2011) and bank (specifically promissory notes, which banks have marketed to individuals as substitutes for time deposits) alike.

The profitability of Spanish deposit institutions remains subject to downward pressures exerted by factors already present in previous quarters, such as diminished activity and a narrowing of spreads between the return on assets and the cost of liabilities. In addition, pressure will also be placed on profits for this year by the greater provisioning requirements introduced by Royal Decree-Law 2/2012, and the weak macroeconomic setting will continue to exert an influence. The restructuring of the sector and its perceptible effect on reducing bank operating costs will, in the medium term, cushion these effects bearing down on profits.

In sum, tensions in the euro area eased from December to March. But since the end of that month they have increased anew on financial markets, while the risks linked to the weakness of economic growth persist. To restore financial markets' confidence in the Spanish economy, it is crucial that the reform and balance-sheet clean-up agenda pursued in the recent period should continue. These measures contribute, moreover, to restoring the macroeconomic balance and competitiveness the Spanish economy needs to resume a sound growth path in the medium term, although some may exert something of a contractionary effect on the more immediate horizon. Significant measures have been taken along these lines in recent months in the financial realm (Royal Decree-Law 2/2012, which accelerates the bank balance-sheet clean-up process), in the fiscal area (reform of the Consitution and the Budgetary Stability Law, which contribute to improving the sustainability of public finances in the medium term, and public spending cuts in various areas) and in respect of structural reforms (most notably the labour market reform, which improves key aspects of the functioning of the labour market and promotes job creation in the medium term). All these measures will help boost long-term economic growth.

The euro area sovereign debt crisis continued to be the main factor bearing on international financial developments during the second half of 2011

During the second half of last year, international financial developments continued to turn on tensions in European financial markets, which heightened from summer 2011 and took on a systemic nature. This turbulence spread to other areas through two channels: first, through a flight to quality, reflected in the appreciation of the dollar and in the decline in yields on US, UK and German government debt; and further, through an increase in the uncertainty surrounding the financial institutions exposed to the euro area, which led to increases in risk premia and falls in stock market values.

From December to March, tensions on European financial markets eased, thanks to certain measures adopted by the European authorities, the Member States and, above all, the ECB…

From December to March, tensions on European financial markets tended to ease. Contributing to this were the measures deployed in various spheres over recent months. At the Summit of Heads of State or Government on 9 December the foundations were laid for a new fiscal discipline and stability pact, and the legal framework that will govern the functioning of the European Stability Mechanism was approved. Further, fiscal, structural-policy and financial measures were adopted in several countries. In Spain, approval was given to a labour market reform and to the deepening of the financial system clean-up, recapitalisation and restructuring process, along with other structural reforms. At its November and December meetings, the ECB cut its official interest rates from 1.5% to 1% and, at the same time, adopted further, non-conventional temporary measures. These included coordinated action with other central banks to provide liquidity in foreign currency, the lowering of the reserve requirement from 2% to 1% and, essentially, the provision of three-year liquidity with full allotment at the auctions held in December and February for an amount close to €1 trillion, whose effects on tensions proved significant. These new auctions were also accompanied by an extension of the range of eligible assets.

… and the successful culmination of the operation involving private-sector participation in the restructuring of Greek debt, which allowed the second aid programme for Greece to be launched

In early March, Greece launched the operation involving private-sector participation in the restructuring of its debt, whereby private creditors agreed to an exchange of assets entailing a 53.5% face value haircut. The agreement was most extensively subscribed to, although the Greek government had to implement collective action clauses. That led to the deal being considered as a credit event by the ISDA, triggering CDSs, while the rating agencies considered it as a selective default. The successful culmination of this operation enabled the second financial assistance programme for Greece to be activated, thereby eliminating one of the sources of uncertainty affecting financial markets.

During this period other sources of uncertainty over the international financial context arose or remained in place

During this period there were also other significant sources of concern, although they bore down less on the markets than those arising from the euro area sovereign debt crisis. Notable among these risks were those associated with the revised growth outlook in certain areas, the need to increase fiscal consolidation in advanced countries, such as the United States and the United Kingdom, and the potential consequences of sustained growth in oil prices, which are already at high levels, insofar as these might have second-round effects jeopardising inflation targets or in terms of the transfer of income involved from importing to exporting countries. In addition, the implementation of certain domestic regulations with a notable extra-territorial impact prompted some concern over the degree of international coordination in terms of regulatory roll-out. Other persistent problems, such as the US housing market situation, continue to give rise to numerous doubts, despite efforts by the authorities to support mortgage securitisations and the fact that at the end of last year it was made known that an agreement had been reached to improve foreclosure processes and compensate households affected by practices arising from these situations.

The measures deployed contributed to improving market confidence and the appetite for risk

The failure of some of the extreme risks envisaged to materialise, action by the main central banks, which have provided high levels of liquidity, and some optimism concerning the figures for economic activity and, in particular, employment in the United States contributed to improving agents' confidence. In addition, the stress tests on several US banks and the release of better-than-expected results for Q1 contributed to shoring up confidence in the US financial sector. These developments prompted a rise on most international stock market indices and there was an increase in the appetite for risk seen, inter alia, in the high volume of bond issues by companies with a low credit rating and in the rise in capital flows towards emerging countries.

The reflection of this in the euro area was an improvement in financial conditions

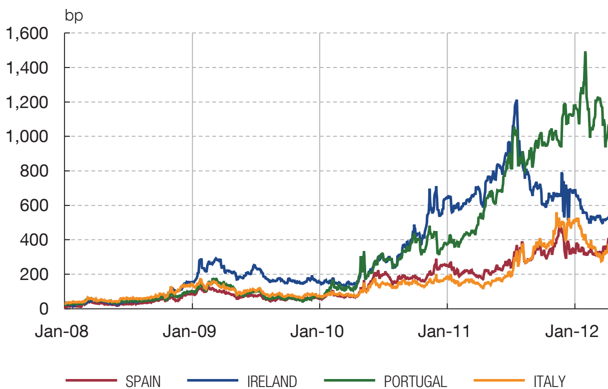
In the euro area financial markets, sovereign debt yield spreads narrowed from November to March in most countries, particularly in Italy and Spain. The risk premia on securities issued by financial institutions also fell and stock market indices rallied (see Chart 1.1). Banks' access to wholesale funding also improved, as testified by the rise in fixed-income issues both by Spanish institutions and by those of other countries.

But since late March there have been renewed tensions on financial markets

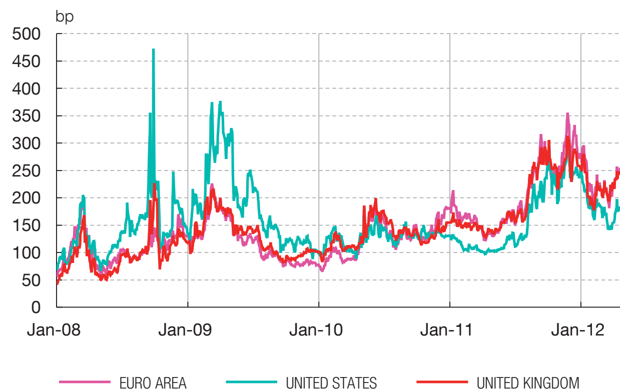
However, from late March tensions renewed on European financial markets, focusing particularly on Spain and Italy, which led to a rise in risk premia. In the case of Spanish 10-year government bonds, the yield briefly breached the 6% mark and the spread over

PRICES NEGOTIATED ON FINANCIAL MARKETS — CHART 1.1

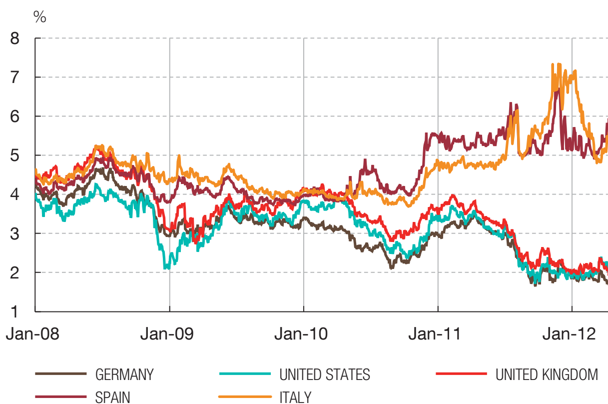
A. TEN-YEAR GOVERNMENT BOND YIELDS: SPREAD OVER GERMANY



B. FINANCIAL SECTOR CREDIT RISK INDEX (a)



C. TEN-YEAR GOVERNMENT BOND YIELDS



D. STOCK EXCHANGE INDICES

SOURCE: Datastream.

a Euro area: 5-year iTraxx Europe Senior Financials. United States and United Kingdom: average 5-year CDS for commercial banks. Latest data: 19 April 2012.

the German benchmark exceeded 440 bp, levels not seen since last November (see Chart 1.1). Stock markets in the euro area, and to a lesser extent in other areas, have been affected by this fresh bout of instability, and indices have fallen back considerably.

Economic activity in the emerging economies moved on a gradual slowing path, albeit posting relatively high rates

During this period the emerging economies continued to show significant resilience. However, the increase in global risk aversion in the second half of 2011 combined with the sluggishness of external demand and the lagged effect of these countries' restrictive economic policies led to less favourable developments in activity and non-financial markets, with capital inflows falling off. Against this backdrop, the gradual slowdown in activity in these economies continued. These effects were more marked in the emerging European economies, with much closer trade and financial links to the euro area. At the other extreme was, once again, the notable resilience of Chinese economic growth, although it has not been immune to the global situation and is slowing somewhat. Inflation rates also tended to ease in the second half of 2011 and early 2012, though they remained relatively high. In this setting of economic deceleration and lower inflation, some central banks tended to ease their monetary policy stance during the second half of the year and, above all, at the onset of 2012. Also in the opening months of the year, the emerging markets benefited from the greater appetite for risk and fresh capital inflows, which prompted upward pressures on exchange rates and, in some cases, monetary policy and macroprudential responses.

In contrast, the developed economies, with the exception of the United States, slowed once more

After a certain rise in activity in the developed economies in 2011 Q3 (thanks in part to the pick-up in the global production chains affected by the Japanese earthquake in March and to the stabilisation of commodities prices), Q4 saw a notable divergence between economic developments in the United States —where the growth rate continued to increase and the labour market showed some signs of a clear improvement— and the rest of the main advanced economies, such as Japan and the United Kingdom, which posted quarterly declines in GDP. Nonetheless, there were signs of stabilisation in early 2012, as the high-frequency indicators of activity and confidence rose. However, economic recovery in these economies is expected to remain weak, in a setting in which there will be less headroom to pursue policies to stimulate growth and to correct the imbalances built up in the expansionary phase. Inflation rates in the advanced economies peaked at the end of 2011 Q3 and, thereafter, gradually fell, against a background of economic sluggishness and with commodities prices easing from their spring 2011 peak. However, these prices have rebounded in early 2012, especially in the case of oil, as a result of demand by the emerging economies and of specific supply-side factors, such as the geopolitical tensions in Iran.

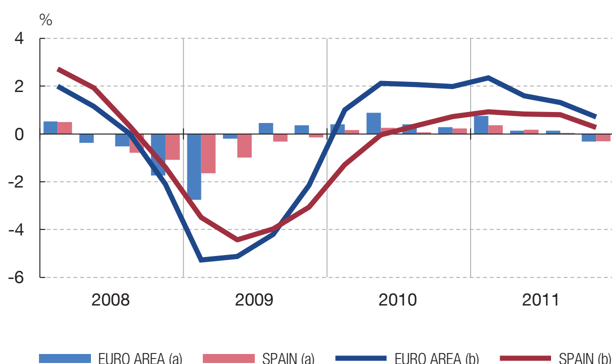
Euro area GDP contracted in 2011 Q4, and the short and medium-term growth outlook was revised downwards. Preliminary figures for 2012 Q1 point to GDP stabilising at a low level

In the euro area, economic activity slowed in the second half of 2011, as a result of the diminishing dynamism of world demand, the ongoing adjustment of private-sector balance sheets, fiscal consolidation plans and the tensions on sovereign debt markets. GDP thus fell by 0.3% in the final quarter of the year, although in year-on-year terms it increased by 0.7% (see Chart 1.2.A). The medium-term outlook has also worsened, as reflected by the downward revisions to economic growth by most analysts and international organisations. Specifically, the ECB's March projections show GDP in a range of between -0.5% and 0.3% for 2012, and between 0% and 2.2% for 2013, meaning lower rates than those in the December projection exercise. The indicators for 2012 Q1 suggest economic activity is stabilising at a low level.

In Spain, GDP contracted in Q4 and job destruction accelerated. The preliminary data available suggest a continuation of these trends

In Spain, GDP posted a quarter-on-quarter decline of 0.3% in Q4, compared with a rate of 0% in the three previous months, while the year-on-year rate was 0.3% (see Chart 1.2.A). Against this background, the pace of job destruction stepped up in the closing months of 2011 to 3.3% year-on-year, with the unemployment rate standing at close to 23% at the end of the year (see Chart 1.2.B). The figures available for the opening months

GDP AND EMPLOYMENT CHART 1.2



SOURCES: INE, Eurostat and Banco de España.

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

of 2012 suggest a continuation of the contractionary pattern of economic activity. The latest projections by leading institutional and private-sector analysts, which are shrouded in great uncertainty, show a significant decline in GDP for 2012 and a moderate recovery for 2013.

The slow ongoing deleveraging of the private sector in Spain continues, while household wealth, like business profits, has continued to fall…

The slow process of deleveraging continues in the private sector, with liabilities posting negative growth rates that are in part countered by the decline in economic activity and the scant increase in income, which means that households and firms both remain subject to a high degree of financial pressure, as evidenced by the increase in doubtful asset ratios. In the case of households, the difficulties derived from high unemployment are accentuated by the ongoing decline in their net wealth, as a result of the fall in real-estate and financial asset prices. The information available on business profits (based on the sample of the firms reporting to the quarterly Central Balance Sheet Data Office survey) reveals a marked deterioration during 2011, which led to declines in profitability ratios.

… while the general government debt and debt burden continue to grow in terms of GDP

In the case of general government, financing requirements remain at high levels, meaning that debt continues to post high growth rates (13.8% in annual terms in February), far outpacing the growth of economic activity. That has translated into further increases in the debt-to-GDP ratio (68.5% of GDP in December), and especially in the debt burden (2.5% of GDP, compared with 2.3% in June), which has also been affected by the increase in interest rates as a result of financial market tensions.

Liquidity risks have lessened, but other risks persist, particularly those linked to the weakness of economic growth

In sum, following the pick-up in the situation on financial markets from December to March, there has been renewed financial turbulence in the euro area, focusing particularly on Spain and Italy. Against this background of greater tensions, the increase in liquidity obtained by Spanish banks from the Eurosystem's three-year tenders provides a significant buffer that lessens the refinancing risks these banks face. Other risks persist, moreover, particularly those linked to the weakness of economic growth.

2.1 Deposit institutions

2.1.1 BANKING RISK

Measures have been taken at the European level and by various countries, including Spain

In recent months, new reforms have been undertaken in Spain in the fiscal area, including a constitutional amendment requiring all the regional governments to adapt their activities to the principle of budgetary stability, and in the labour market, among others. In addition, further measures have been taken in relation to the banking sector.

In the Spanish banking sector additional measures have been taken to write down the real estate assets of banks whose balance sheet value is subject to most uncertainty

As regards the measures taken in relation to the Spanish banking sector, February 2012 saw the approval of RDL 2/2012, which aims to eliminate the uncertainty surrounding the valuation on banks' balance sheets of assets connected with construction and real estate development, and in particular that associated with assets relating to land and developments under construction. Despite these new measures to clean up banks' balance sheets, the environment in which Spanish banks have to operate remains difficult, given that wholesale funding markets have yet to return to normal. Moreover, the macroeconomic situation in Spain remains adverse, as reflected in the increase in tensions on financial markets since the end of March this year, following their fall between December 2011 and March 2012.

The consolidated balance sheet shows modest growth…

The **consolidated balance sheet** for all deposit institutions, which includes their activity in Spain and that of their subsidiaries abroad, shows a growth rate of 3% in December 2011 in relation to the same period of the previous year (see Table 2.1). Total assets thus amounted to €3,901 billion at the end of last year.

…and the fall in financing to the private sector continues

Financing to the private sector, understood as credit and fixed income, fell by 1% in December 2011 with respect to December 2010 (see Table 2.1), owing to the declines in both fixed-income securities and in credit to the private sector. The determinants of the developments in this variable relate to the macroeconomic environment, which has negatively affected the credit quality of bank customers, leading banks to raise their credit standards. Another element of downward pressure on the supply side was the tensions on funding markets which, while having been partially relieved by the measures approved by the ECB in December 2011, had an impact on the ability of banks to offer financing to customers. The weakness of the economic situation also results in lower demand for funds by firms and households, which adds to a more structural development, namely the reduction in the borrowing that these sectors have been undertaking to correct the imbalances built up during the upswing.

Financing to Spain's general government increases, but its weight in the sector's balance sheet is significantly lower than in the past

Financing to general government (credit and fixed income) increased by 12% relative to December 2010, its weight in the consolidated balance sheet increasing from 9.4% in December 2010 to 10.2% in December 2011. In recent months the weight of credit and fixed income of Spanish general government in Spanish banks' business in Spain has grown (see Chart 2.1.A), a trend that persisted in January 2012, when the financing to Spain's general government reached 9.4% of the total assets of business in Spain. This trend can be expected to go into reverse when the downward trend in credit to the resident private sector does. In any case, taking a longer perspective, and subject to the caveats applicable to the analysis of this type of trend, while the weight of financing to Spanish general government in the banking sector's business in Spain has increased in recent years, it is still far below the level seen in the mid-1990s (see Chart 2.1.A). Compared with other EU countries, Spanish banks' government debt holdings are in line with the average for the European banking sector.

CONSOLIDATED BALANCE SHEET. DEPOSIT INSTITUTIONS — TABLE 2.1

Assets	Dec-11	Change Dec-11/Dec-10	Relative weight Dec-10	Relative weight Dec-11
	(€m)	(%)	(%)	(%)
Cash and balances with central banks	154,065	25	3.2	3.9
Loans and advances to credit institutions	195,259	-9	5.7	5.0
General government	101,019	13	2.4	2.6
Other private sectors	2,369,482	-1	62.9	60.7
Debt securities	495,759	2	12.8	12.7
Other equity instruments	44,879	-27	1.6	1.2
Investments	53,602	9	1.3	1.4
Derivatives	240,769	37	4.6	6.2
Tangible assets	50,963	2	1.3	1.3
Other (a)	195,140	24	4.1	5.0
TOTAL ASSETS	**3,900,936**	**3**	**100**	**100**
MEMORANDUM ITEMS				
Financing to private sector	2,485,840	-1	66.3	63.7
Financing to general government	398,986	12	9.4	10.2
Total doubtful assets	160,083	24	3.4	4.1
Total doubtful assets ratio	5.1	99 (c)		
Provisions for bad debts and country risk	-90,734	6	-2.2	-2.3

LIABILITIES AND EQUITY	Dec-11	Change Dec-11/Dec-10	Relative weight Dec-10	Relative weight Dec-11
	(€m)	(%)	(%)	(%)
Balances from central banks	207,312	118	2.5	5.3
Deposits from credit institutions	467,776	-7	13.2	12.0
General government	89,278	-8	2.5	2.3
Other private sectors	1,771,690	-2	47.9	45.4
Marketable debt securities	525,523	-4	14.4	13.5
Derivatives	223,509	38	4.3	5.7
Subordinated debt	89,818	-15	2.8	2.3
Provisions for pensions, tax and other	32,265	-10	0.9	0.8
Other (a)	261,570	23	5.6	6.7
TOTAL LIABILITIES	**3,668,741**	**3**	**94.2**	**94.0**
MEMORANDUM ITEMS				
Eurosystem net lending (b)	227,600		1.1	5.8
Minority interests	24,218		0.4	0.6
Valuation adjustments relating to total equity	-11,417		-0.1	-0.3
Own funds	219,394		5.5	5.6
TOTAL EQUITY	**232,195**	**6**	**5.8**	**6.0**
TOTAL LIABILITIES AND EQUITY	**3,900,936**	**3**	**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 2012 data.
c Difference calculated in bp.

Doubtful assets grow and so too does the doubtful assets ratio

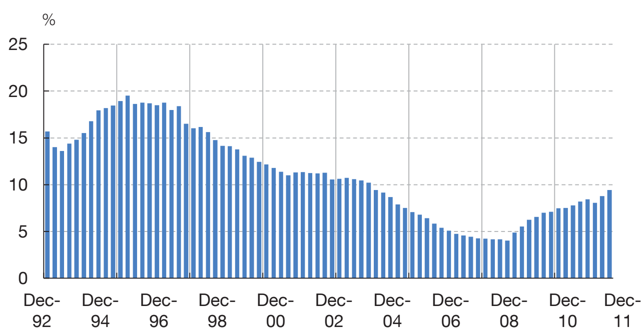
The total doubtful assets ratio[1] at the consolidated level stood at 5.1% in December 2011, as against 4.5% in June 2011 and 4.1% a year earlier. As is analysed in greater detail below, with regard to business in Spain, additional increases in doubtful assets are to be expected in the next few quarters given the macroeconomic scenario for 2012.

1 Total doubtful assets include, in addition to those of the resident private sector, which are analysed in greater detail below, those of general government, credit institutions and fixed-income securities on banks' consolidated balance sheets.

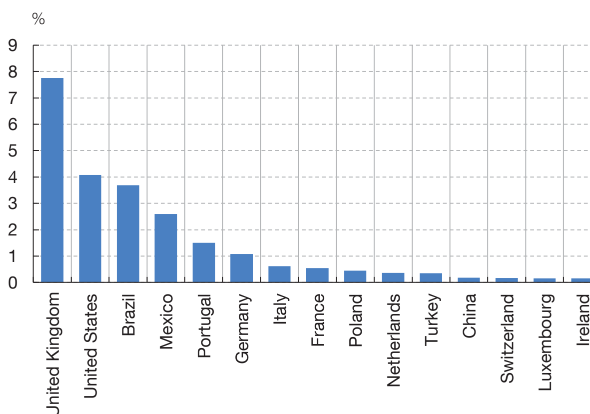
CREDIT AND FIXED INCOME OF THE SPANISH PUBLIC SECTOR (BUSINESS IN SPAIN) AND FOREIGN CONSOLIDATED ASSETS OF SPANISH BANKS

CHART 2.1

A. CREDIT AND FIXED INCOME OF THE SPANISH PUBLIC SECTOR AS A PERCENTAGE OF TOTAL ASSETS. BUSINESS IN SPAIN, ID



B. CONSOLIDATED FOREIGN FINANCIAL ASSETS AS A PERCENTAGE OF THE CONSOLIDATED TOTAL ASSETS OF SPANISH DEPOSIT INSTITUTIONS. DECEMBER 2011



SOURCE: Banco de España.

The increase in the derivatives item on the assets side is offset by a similar increase on the liabilities side, and largely reflects hedging operations carried out by some deposit institutions. The assets heading “other” includes elements that are not explicitly detailed in the table. Its increase stems from several of these, in particular “stocks” and “non-current assets held for sale”, reflecting asset foreclosure processes.

The uptake of financing from the Eurosystem increases, under the measures adopted in December 2011

On the **liabilities** side, there was a notable increase in central bank deposits, which grew by 118% in December 2011 relative to the same period of 2010. Net borrowing from the Eurosystem in March 2012 amounts to 5.8% of the total balance sheet in December 2011. The increase in the recourse to ECB financing reflects the increase in tensions in financial markets in the euro area. These tensions led the ECB to adopt measures in December 2011 (see Box 2.2), and in particular to announce two unlimited three-year refinancing operations.

The tensions on the wholesale funding markets are reflected in marketable debt securities, which are falling, their weight in the balance sheet remaining on a downward trend. Subordinated debt is falling more sharply, partly owing to the loss of attractiveness of an instrument that, for the purposes of capital regulation, is not counted in the most demanding ratios, these being the ones that have recently received greater attention both from the markets and from regulators and supervisors.

Other private sectors show in December 2011 a year-on-year fall, at the consolidated level, of 2%. As analysed below for business in Spain, this decline is explained both by the slackness of the macroeconomic environment, and by the competition from other financial instruments.

As in the case of assets, the liabilities heading “other” includes those items not explicitly detailed in Table 2.1. Its increase is mostly explained by the increase in repos.

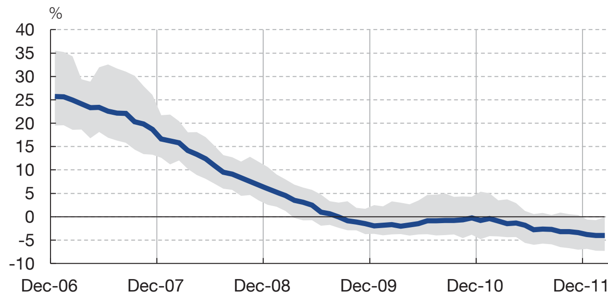
The weight of own funds in total assets increases

Own funds grew by 5% in December 2011 relative to the same period of the previous year, their relative weight in the balance sheet amounting to 5.6%, while equity, relative to assets, increases to 6% from 5.8%.

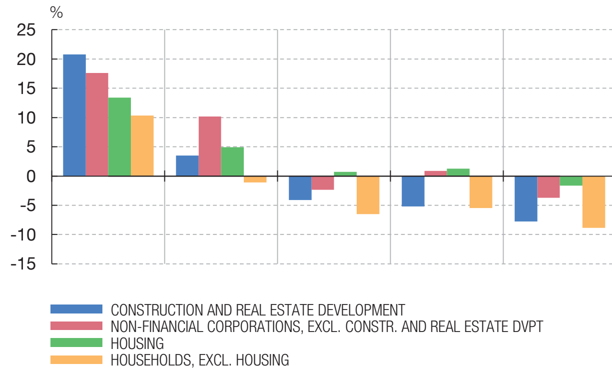
CREDIT TO THE RESIDENT PRIVATE SECTOR, BUSINESS IN SPAIN
Deposit institutions, ID

CHART 2.2

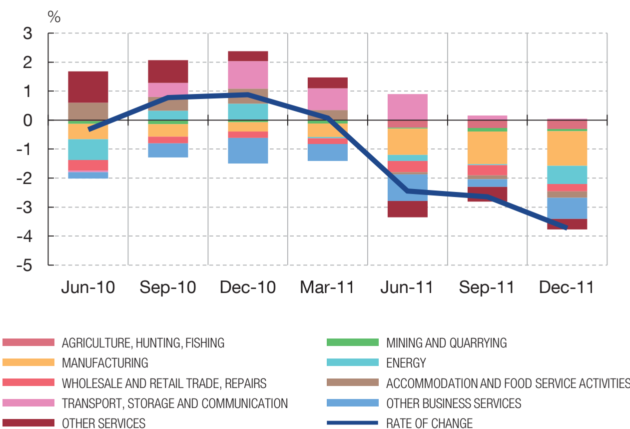
A. CREDIT TO THE RESIDENT PRIVATE SECTOR AND DISPERSION ACROSS INSTITUTIONS (a)



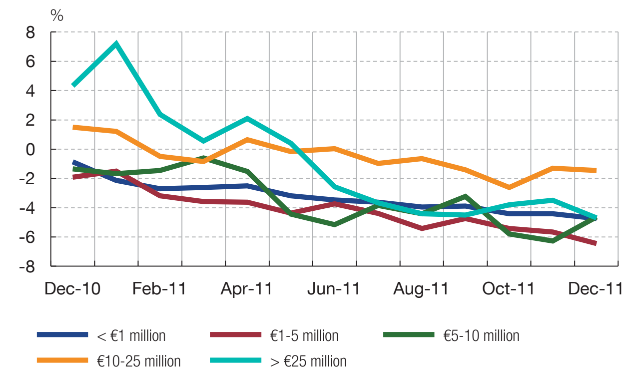
B. CREDIT TO THE RESIDENT PRIVATE SECTOR BY SECTOR OF ACTIVITY



C. CONTRIBUTIONS TO THE RATE OF CHANGE IN CREDIT TO NON-FINANCIAL CORPORATIONS, EXCLUDING CONSTRUCTION AND REAL ESTATE DEVELOPMENT, OF DIFFERENT SECTORS OF ACTIVITY



D. CREDIT TO NON-FINANCIAL CORPORATIONS, EXCLUDING CONSTRUCTION AND REAL ESTATE DEVELOPMENT BY SIZE OF CORPORATION (b)



SOURCE: Banco de España.

a The shaded area represents the institutions´ dispersion between the 10th and the 90th percentiles for changes in credit.
b Corporation size is proxied by the volume of bank debt reported to the Banco de España Central Credit Register.

The external exposure of Spanish banks is geographically diversified and has been assumed by financially autonomous subsidiaries

The distribution of the **external financial assets** of Spanish deposit institutions shows the relative importance of traditional areas of expansion, such as Mexico and Brazil, and of other more recent ones, in particular the United Kingdom and the United States (see Chart 2.1.B). The relative importance of exposure to other geographic areas, including other European countries, is quantitatively more limited. From the viewpoint of the valuation of the risks implied by these exposures, it should be taken into account that irrespective of the area the exposures are to, they are generally exposures of subsidiaries that carry out their activity in the countries concerned with financial autonomy, that the activity is mostly local and denominated in local currency, and that they do not relate to loans made by the parent entity in Spain.

Credit to the resident private sector in Spain falls…

Credit to the resident private sector in Spain, according to individual financial statement data, shows a year-on-year decline of 3.8% in December 2011 (see Chart 2.2.A). The latest data, relating to February 2012, show a decline in this variable of 4.0%. The trend observed during 2011, after credit returned to slightly positive levels or very modest falls at the end of 2010, is thus intensifying (see Chart 2.2.A). This behaviour of credit is sector wide; with just the odd exception all the institutions have been showing negative rates of

change recently, although there continues to be a notable dispersion in the rates at which this variable is falling (see Chart 2.2.A).

…owing to both demand and supply factors

The fall in credit stems from demand-side factors; demand is less strong owing to the weakness of the economic situation, and also partly due to the necessary deleveraging by households and non-financial corporations. This process should be carried out in an orderly fashion and be focused on those sectors in which the largest imbalances were concentrated during the pre-crisis years, in particular the construction and real estate development sector. It is also consistent with an intensification of supply restrictions, for two reasons. First, the poorer macroeconomic outlook is having a negative impact on the credit quality of potential borrowers. Second, banks' funding difficulties intensified very significantly (not only in Spain), although they eased thanks to the measures taken by the ECB from December last year. The new measures approved by the government, which are incorporated in RDL 2/2012, introduce further incentives for those assets most closely related to such imbalances to be taken off banks' balance sheets (see Box 2.1). In any event, credit cannot be expected to pick up during the next few months.

The reduction in credit is seen both for individuals…

Lending to individuals fell by 2.9% in December 2011 relative to the same period of 2010. The rate of decline is especially strong in the case of lending for purposes other than house purchase (–8.8% in December 2011 with respect to December 2010), although this rate has stabilised somewhat at around these levels (see Chart 2.2.B). Lending to individuals for house purchase fell by 1.6% in December 2011 year-on-year. This rate is well below the one mentioned above for other lending to households, but the recent rate of decline is notable.

…and non-financial corporations, the fall in this case being concentrated in the construction and real estate development sector

As regards non-financial corporations, the rate of decline of credit (–5.7% in December 2011 with respect to December 2010) is basically explained by the reduction in credit to construction and real estate development firms (–7.8% in December 2011, year-on-year). For other non-financial corporations the decline is more moderate (–3.7% in December 2011), although broadly based across sectors (see Chart 2.2.C). The broad-based nature of the decline in credit is also apparent when firms are considered according to their size, measured in terms of the volume of bank debt reported to the Banco de España Central Credit Register.

The increase in doubtful assets largely stems from those originating in credit to construction and real estate development…

Doubtful assets arising from credit to the resident private sector in business in Spain grew at a rate of 32% in December 2011 in relation to the same period a year earlier. The rise in the rate of increase in doubtful assets dates back to the final quarter of 2010 (see Chart 2.3.A), and is basically explained by the increase in doubtful assets associated with the construction and real estate development sector (see Chart 2.3.B). The doubtful assets arising from credit to households and other business sectors have been growing during 2011, although their contribution to the volume of new doubtful assets is limited. Thus, of the total increase in doubtful assets last year, 23.5% is attributable to non-financial firms other than those in the construction and real estate development sector and 5.6% to households.

The increase in doubtful assets and the progressive reduction in credit result in a substantial increase in the doubtful assets ratio, which in December 2011 reached 8%, as against 5.8% a year earlier (see Chart 2.3.C). The February data put the ratio at just above 8%, close to the peak recorded in 1993 (8.5%; see Chart 2.3.D). However, when construction and real estate development is excluded, the doubtful assets ratio stands at significantly more moderate levels (4.2% in December 2011).

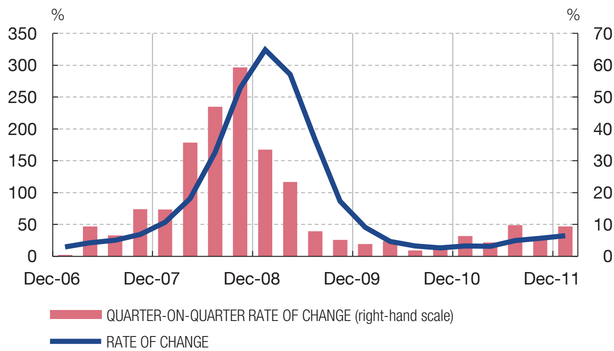
…which has a significantly higher doubtful assets ratio…

The construction and real estate development sector has a significantly higher doubtful assets ratio (20.9% in December 2011, as against 13.5% in December 2010). Moreover,

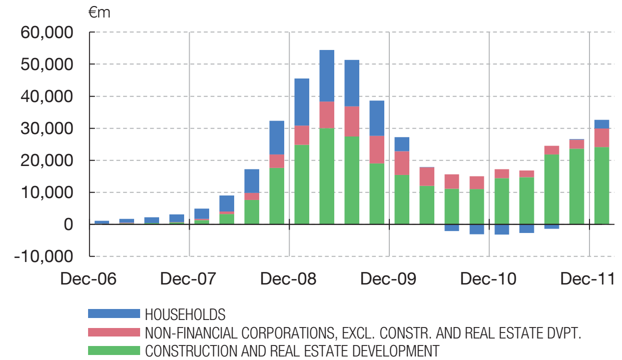
DOUBTFUL ASSETS AND DOUBTFUL ASSETS RATIO FOR CREDIT TO THE RESIDENT PRIVATE SECTOR. BUSINESS IN SPAIN
Deposit institutions, ID

CHART 2.3

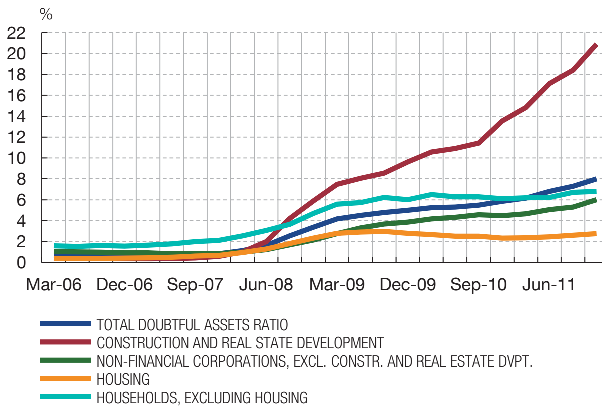
A. RATE OF CHANGE IN DOUBTFUL ASSETS



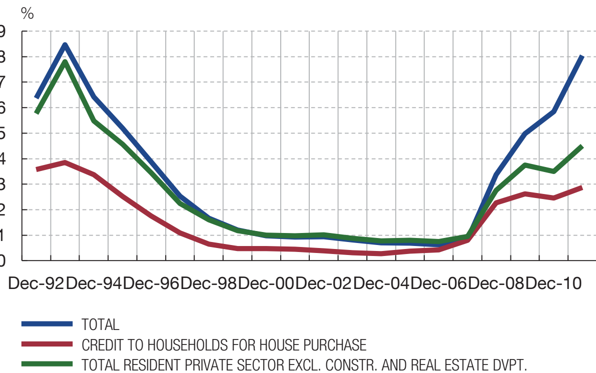
B. YEAR-ON-YEAR CHANGE IN DOUBTFUL ASSETS



C. DOUBTFUL ASSETS RATIO BY SECTOR



D. HISTORICAL PERFORMANCE OF THE DOUBTFUL ASSETS RATIO



SOURCE: Banco de España.

when not only doubtful assets are included, but also foreclosures and substandard assets, the troubled assets associated with real estate development amount to 60% (see Box 2.1).

In mid-2010 the Banco de España increased its transparency requirements for institutions in relation to their real estate exposures. However, amid the climate of greater deterioration in the macroeconomic and financial environment in Spain and in the euro area in the second half of 2011, there was a worsening of the impact on bank balance sheets of the uncertainty surrounding the value of assets related to the construction and real estate development sector, and in particular surrounding land and developments in progress, for which no sufficiently active market exists. This led to approval of a new set of measures to clean up the sector´s balance sheets (see Box 2.1).

One of the areas that arouses most interest in the market, regarding the Spanish financial sector, is its exposure to the construction and real estate development sector, as well as to financing for house purchase and the volume of assets acquired in payment of debt. Thus, in order to strengthen and improve the reporting of exposure to the real estate sector required by the Banco de España, Circular 5/2011 was published on 30 November 2011. This Circular requires more transparency in the semi-annual and annual reporting, and also includes a requirement for confidential information, with the aim of achieving a harmonised and comparable breakdown and presentation of the quantitative information so reported.

NEW MEASURES TO CLEAN UP FINANCIAL SECTOR BALANCE SHEETS APPROVED BY ROYAL DECREE-LAW 2/2012

BOX 2.1

Royal Decree-Law (RDL) 2/2012, approved ten weeks after the new Government came into power, introduces new measures to write down assets related to the construction and real estate development sector with the aim of strengthening the credibility of, and confidence in, the Spanish banking system. This clean-up has been focused on land and developments in progress in particular, since these are the assets whose value is subject to most uncertainty, owing to the absence of sufficiently deep markets, in terms of volume and importance of transactions.

In mid-2010, the Banco de España amended its provisioning rules, in order to increase the level of institutions' provisions and also to generate incentives for these assets to be taken off banks' balance sheets. In 2011, to give greater visibility and full transparency to the process, institutions were required to publish extensive details of their real estate exposures. However, these measures have not been sufficient to eliminate the uncertainty regarding the value of assets related to the real estate sector, in particular land, against a background of ongoing adjustment in this sector and a sharp deterioration in the macro-financial conditions in the euro area, especially in the second half of 2011.

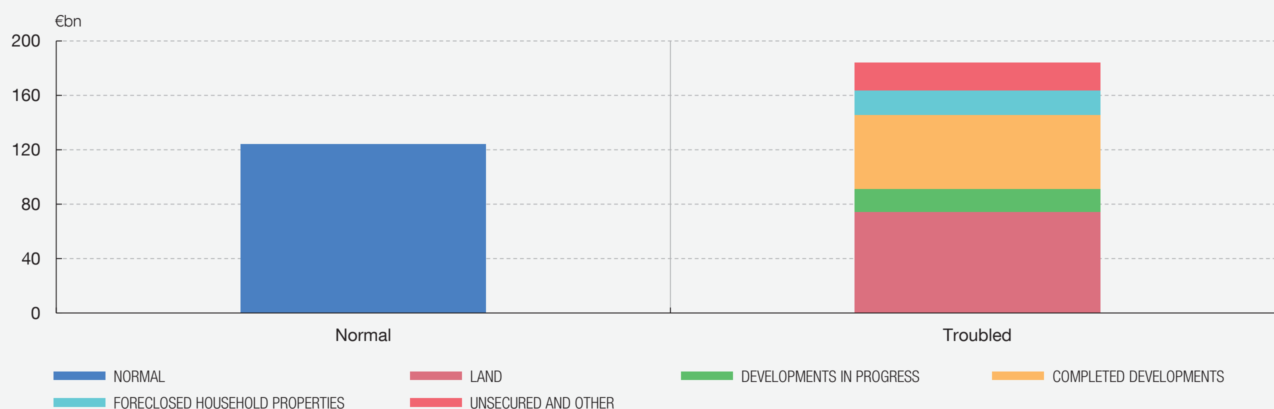
The new measures apply to the total volume of troubled assets of the construction and real estate development sector as at 31 December 2011. Troubled assets are deemed to be doubtful loans (due to late payment or other reasons), sub-performing loans and foreclosed assets. These assets totalled €184 billion in December 2011, amounting to 60% of the whole construction and development portfolio, which has a total value of €308 billion (see Chart A). This percentage of assets recognised as impaired is very significant.

New core capital and provisioning requirements

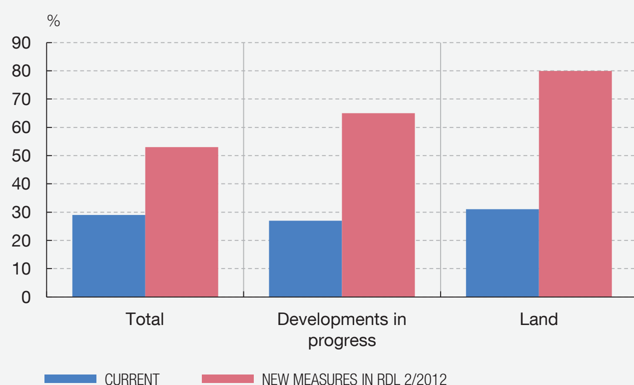
These new write-downs are carried out through three elements: specific provisions, capital surcharges and provisions for normal investment:

– Specific provisions: additional specific provisions are established to cover the losses incurred on portfolios of troubled assets. Without going into all the details specified in RDL 2/2012, the additional provisions required by this rule arise from five sources. First, the provisions for all assets

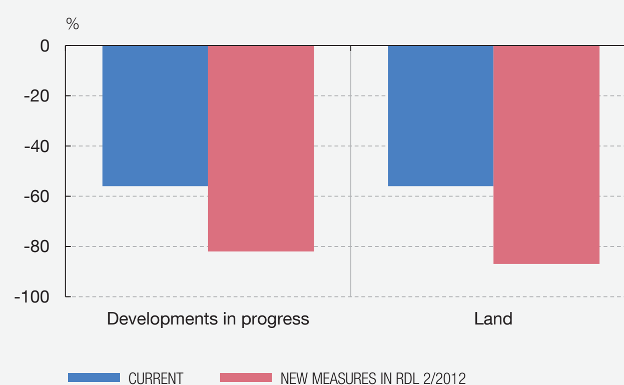
A. EXPOSURE TO CONSTRUCTION AND REAL ESTATE DEVELOPMENT, INCLUDING FORECLOSED PROPERTIES OF HOUSEHOLDS



B. COVERAGE RATIOS



C. FALL IN THE VALUE OF LAND AND DEVELOPMENTS IN PROGRESS COMPATIBLE WITH THE NEW COVERAGE RATIOS CONSIDERING THE PORTFOLIOS´ MEAN LTVs



SOURCE: Banco de España.

related to land must be raised to 60% of book value. Second, for assets related to developments in progress, the level of provisions must be raised to 50%, except for developments in progress classified as sub-performing, in which case the coverage must be 24% (the volume of assets in this situation is estimated to be around €2 billion). Third, for foreclosed assets in the form of completed developments and other collateral the value of coverage ratios is increased to 50% and they are extended to a fourth year. Four, for foreclosed dwellings of households the requirement for coverage is extended to a fourth year with a ratio of 40%. And fifth, for the other loans to this sector the minimum provision for doubtful assets is established as 25% of the gross value of the loan and the coverage percentage is raised for operations classified as sub-performing from 10% to 20% or 24%, depending on whether they are collateralised.

– Capital surcharge: this is required for troubled assets related to land and developments in progress, and the reason for it is that there is greater uncertainty over their value owing to the absence of a market and significant transactions. The surcharge is established in such a way that the coverage of the assets related to land is raised from 60% to 80%, and for developments in progress from 50% to 65%. It hinges on the regulatory requirement for core capital in force in Spain since the approval of RDL 2/2011.

– For the standard construction and real estate development portfolio a requirement is established to set aside, in addition to the general provision, a one-off independent provision of 7% of the outstanding amount as at 31 December 2011 of all financing relating to land for real estate development and to construction or real estate developments classified as standard.

The amount so calculated can only be used to cover the needs arising from subsequent reclassifications of the loans that serve as the basis for the estimation, or from the receipt of assets in payment of such loans.

The application of the first two elements described above involves a very significant increase in the coverage for the total troubled portfolio (from 29% to 53%), in particular for developments in progress (from 28% to 65%) and for land (from 33% to 80%, see Chart B). Taking into consideration the average LTVs of both portfolios, these levels of coverage would be compatible with falls in the initial values of land and developments in progress of 82% and 87%, respectively (see Chart C).

On 17 April 2011, the Banco de España, meeting the first deadline established by RDL 2/2012, concluded the process of approval of the plans of the institutions or groups of institutions, which had been submitted by 31 March. In total, the institutions have notified a need for further provisions of €29,077 million, in addition to the €9,192 million already set aside before the end of 2011. Additional core capital requirements of €15,573 million must be added to these amounts.

Thus, the total amount of provisions and core capital that institutions are required to set aside is €53,842 million. This comes on top of the efforts institutions have made to clean up their balance sheets since 2008, which have involved a total write-down of €112 billion.

Of the the total number of institutions and groups of credit institutions, 90 have notified the Banco de España that they already met the new requirements as at 31 March 2012. The other 45 have communicated their plans, according to which compliance will basically be achieved through the use of general provisions amounting to €4 billion, the retention of earnings for the year and capital contributions estimated at €12.5 billion, taking into account that many institutions have more than enough “core capital”. Two institutions have notified their intention to participate in integration processes with two other institutions to meet the new requirements. In the case of the three institutions controlled by the FROB (Banco de Valencia, Catalunya Banc and NCG Banco), the balance sheet restructuring will involve the entry of new shareholders through a process of sale in accordance with the provisions of RDL 9/2009 of 26 June 2009.

As established by RDL 2/2012, institutions must cover the new requirements during the course of this year, except in those cases in which merger processes are to be carried out this year. Thus, when mergers between institutions are planned, a deadline of 31 May is established for submitting the plan, which requires the approval of the Ministry for Economic Affairs. When the plan has been approved, the Ministry having one month in which to make a decision, the institution then has 12 months in which to comply with the requirements of RDL 2/2012 and the integration process must be completed by 1 January 2013.

RDL 2/2012 lays down certain conditions for mergers (the minimum size of the resulting institution, corporate governance improvements, targets for the financing of households and SMEs, targets for reducing exposure to construction and real estate development, etc.) and authorises the FROB, where necessary, to contribute securities convertible into shares within 5 years.

The plans notified to the Banco de España envisage another five takeover or merger processes involving eleven institutions, which are at various different stages. Twelve credit cooperatives may also participate in integration operations, which does not necessarily imply that they are availing themselves of the special merger regime of RDL 2/2012 described above.

By means of Circular 2/2012, the Banco de España made the legal changes envisaged in the Royal Decree-Law to adapt the requirements in relation to provisions to Circular 4/2004 on public and confidential reporting rules.

Conclusions

– In short, RDL 2/2012 establishes strict additional requirements to increase the write-downs of Spanish banks on their

exposures to the construction and real estate development sector and, in particular, for assets related to land and work in progress. These assets do not have a sufficiently active market establishing reference prices, so that their true value is subject to some uncertainty. RDL 2/2012 helps to eliminate this uncertainty, by requiring provisions to be made (of 80% for land and 65% for work in progress) that are compatible with falls in the value of land and work in progress of 87% and 82%, respectively.

– The plans approved by the Banco de España show that the new provisions, have in most cases been made already, or will be made without great difficulty, despite the significant impact on the income statement. In other cases compliance is expected to be more difficult, so that the BE intends to step up its vigilance and has required additional contingency measures to improve the chances of success. However, if any institution, owing to the significant restructuring and recapitalisation efforts, ultimately fails to achieve the required level of core capital, on its own or through participation in an integration process, it may apply to the FROB for the assistance provided for.

The Banco de España has indicated on various occasions that asset foreclosure is a normal mechanism for dealing with collateralised assets that have become classified as troubled. However, this process must be temporary, so that institutions can focus on their basic activity, namely attracting savings to channel towards productive activities.

…than other non-financial corporations…

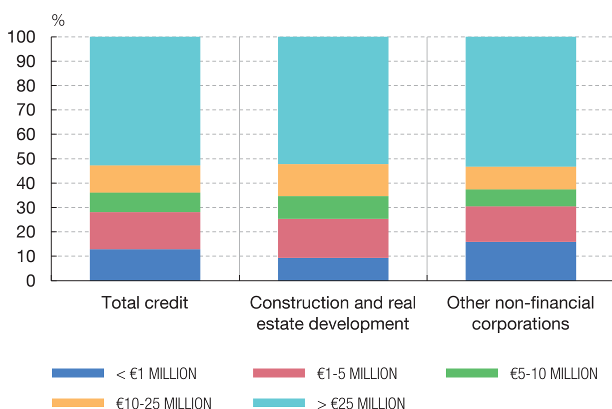
Other lending to non-financial corporations shows a rising, but more moderate doubtful assets ratio (6% in December 2011, as against 4.5% a year earlier). Excluding larger firms, identified by the volume of their bank debt in the CCR, the doubtful assets ratio is, to date, relatively similar across the different types of firm (see Charts 2.4.A and B).

…and individuals

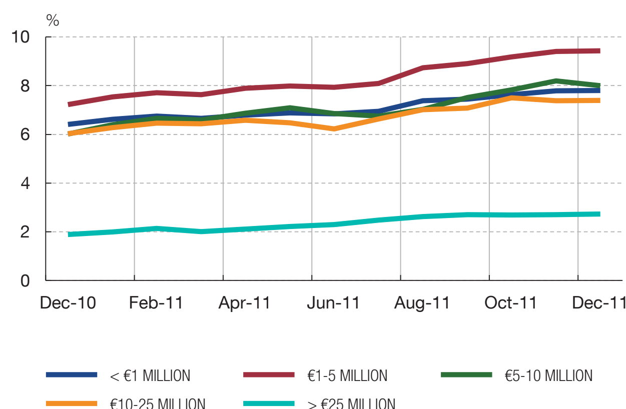
In the case of credit to individuals, the doubtful assets ratio was 3.4% in December 2011, as against 3% a year earlier (see Chart 2.3.C). Notable differences persist in the level of the ratio according to the purpose of the credit. Thus, for credit for purposes other than house purchase, the doubtful assets ratio is 6.8% in December 2011. For credit to individuals for house purchase, which accounts for 84% of total credit to individuals, the doubtful assets ratio was 2.8% in December 2011. Although it has increased with respect to December 2010 (2.3%), the rise has been moderate.

CREDIT AND DOUBTFUL ASSETS RATIO OF NON-FINANCIAL CORPORATIONS. BUSINESS IN SPAIN CHART 2.4
Deposit institutions, ID

A. BREAKDOWN OF CREDIT TO NON-FINANCIAL CORPORATIONS BY CORPORATION SIZE (a)



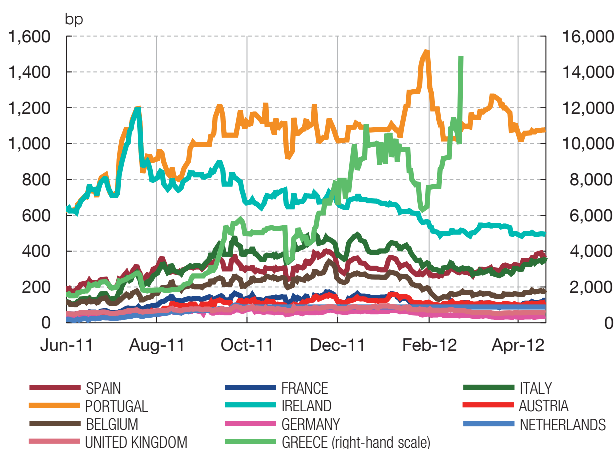
B. DOUBTFUL ASSETS RATIO OF CREDIT TO NON-FINANCIAL CORPORATIONS, EXCLUDING CONSTRUCTION AND REAL ESTATE DEVELOPMENT, BY SIZE OF CORPORATION (a)



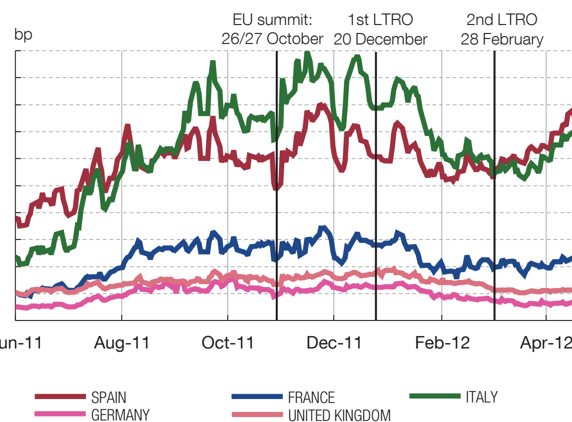
SOURCE: Banco de España.

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

A. 5-YEAR SOVEREIGN DEBT CDS (ABSOLUTE VALUE)
Latest data: 19 April 2012



B. 5-YEAR SOVEREIGN DEBT CDS (ABSOLUTE VALUE). SELECTED COUNTRIES. Latest data: 19 April 2012



SOURCE: Datastream.

In a macroeconomic scenario like the current one, with forecasts of significant year-on-year falls in GDP and unemployment rates of around 24%, one can expect the doubtful assets ratio in the case of credit to individuals for house purchase to rise. However, this increase should be moderated by certain characteristics of the retail mortgage market in Spain, specifically the importance of owner occupied housing, the legal framework and the banking model pursed by Spanish institutions, with the marketing of more risky mortgage products and services (buy-to-let mortgages or mortgages to finance consumer goods) being uncommon. Mindful of the limitations of historical comparisons, it may be noted that in 1993 the doubtful asset ratio for this segment of the credit portfolio reached 4% (see Chart 2.3.D). At that time the unemployment rate stood at 24%, and interest rates were at around 14%, well above the mortgage rates prevailing today, although debt was lower and exit from the crisis was faster.

The financial tensions in the euro area…

The second half of 2011, and in particular the final quarter of the year, was characterised by a notable resurgence of **financial tensions in the euro area,** driven by various factors that interacted with one another, notably the worsening and extension of the sovereign debt crisis, the uncertainty surrounding the banking sector and the deterioration of the macroeconomic outlook. These renewed tensions were apparent in various financial indicators, and in particular in the widening of euro area country debt spreads (see Charts 2.5.A and B).

…led to the adoption of different measures by the authorities

The worsening and spreading of the problems led to a summit of Heads of State or Government on 26 October 2011, which resolved to act in three areas. First, a solution for Greece was agreed, including the voluntary acceptance by the private sector of a nominal discount on notional Greek debt of around 50%. Second, an expansion of the Financial Stability Facility (EFSF) was agreed. And third, a programme to recapitalise the larger banks was designed, which included a requirement for core Tier 1 capital of 9% and for capital to cover the potential losses on European Economic Area sovereign debt portfolios.

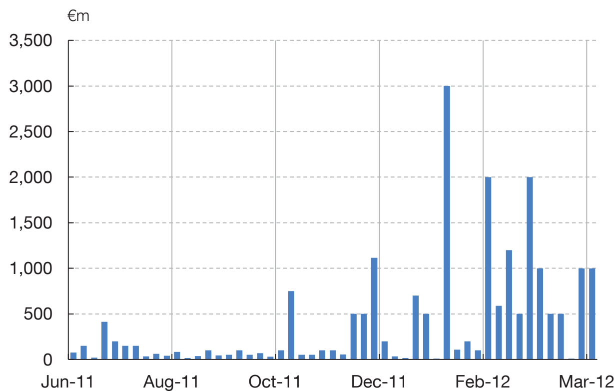
... including those adopted by the Eurosystem in December 2011

In spite of these agreements, tensions persisted in the euro area financial markets (see Charts 2.5.A and B), the medium and long-term primary wholesale funding markets remaining practically closed, while severe tensions persisted in the short-term ones.

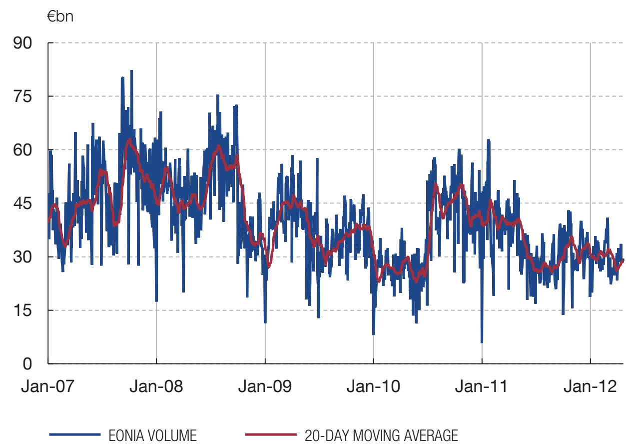
WHOLESALE FUNDING

CHART 2.6

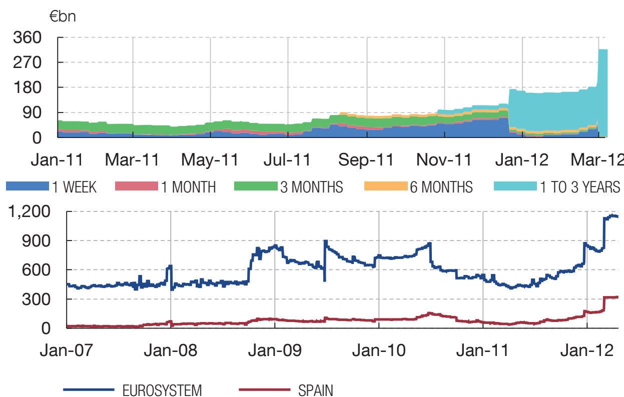
A. MAIN ISSUES OF SPANISH INSTITUTIONS IN MEDIUM AND LONG TERM WHOLESALE MARKETS
Latest data: 13 March 2012



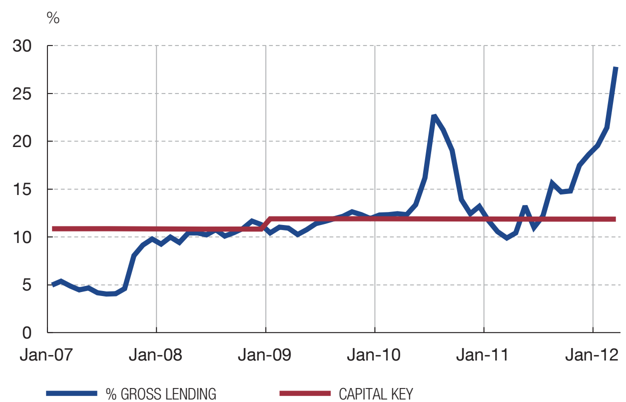
B. EONIA TRADING VOLUME
Latest data: 19 April 2012



C. EUROSYSTEM GROSS LENDING TO SPANISH INSTITUTIONS BY TERM (upper panel) AND OUTSTANDING AMOUNT PROVIDED THROUGH EUROSYSTEM TENDERS (lower panel). Latest data: 19 April 2012



D. EUROSYSTEM GROSS LENDING TO SPAIN AS A PERCENTAGE OF TOTAL LENDING.



SOURCES: Bloomberg and Banco de España.

Thus, at the beginning of December 2011, the ECB announced a series of measures (see Box 2.2), notable being the approval of two three-year refinancing operations to be conducted through a fixed-rate tender procedure with full allotment, in addition to those adopted at the European level at the Summit of Heads of State or Government of 9 December and those approved by various countries in the areas of fiscal consolidation and structural reform. On top of all this came the second Greek rescue programme.

This set of measures eased the tensions and a number of European institutions, including various Spanish ones, issued debt in the first few months of 2012, although tensions have reappeared on financial markets since March

All these decisions and measures, and in particular those agreed by the ECB, contributed notably to easing tensions (see Chart 2.5.B). In the first few months of the year there was a new window of opportunity for issuance on primary funding markets, which had in preceding months been practically closed to most euro area financial institutions. Spanish institutions, as in the past when windows of opportunity of this type have opened in the markets, issued debt in the first three months of the year. Although the amount of issuance varied from one institution to another, a total of €12.7 billion of debt was placed, of which somewhat more than half was in the form of mortgage covered bonds (see Chart 2.6.A). However, since March tensions have reappeared on financial markets, which despite their improvement have remained highly volatile.

Given the persistence of the European sovereign debt crisis, the Eurosystem has adopted various measures in recent months in an attempt to counter its adverse effects on funding markets. Thus, in addition to cutting its official interest rates in November and December 2011, it has launched measures to correct market malfunctioning and smooth European credit institutions' access to funding.

Specifically, in December 2011 the ECB Governing Council decided, first, to conduct two longer-term refinancing operations (LTROs) with a maturity of 36 months and the option of early repayment after one year.[1] These operations took place in December 2011 and February 2012 as fixed-rate tender procedures with full allotment, with the interest rate fixed at the average rate of the main refinancing operations (MROs) over the life of the respective operation. Further, it decided to discontinue the fine-tuning operations conducted on the last day of each reserve maintenance period. As to other operations, it has retained the use of the fixed-rate procedure with full allotment both for MROs and for maintenance period operations. Refinancing operations with a maturity of three months have continued to be conducted through the fixed-rate full allotment procedure, where the rate is the average rate of the MROs over the life of the respective three-month operation.

Furthermore, the reserve ratio was reduced from 2% to 1%. In the current context of excess liquidity, apparent in the extensive use of the deposit facility, it is possible to reduce reserve requirements to control money market conditions.

Also included in the batch of measures approved in December 2011 were changes relating to collateral eligibility criteria for the Eurosystem's credit operations. In this respect, in order to increase collateral availability the credit rating threshold for certain asset-backed securities was reduced. Also, as a temporary solution, national central banks (NCBs) were allowed to accept as collateral additional performing credit claims that satisfy specific eligibility criteria. Subsequently, in February 2012, the national frameworks proposed by the central banks of Ireland, Spain, France, Italy, Cyprus, Austria and Portugal were approved. To date, the use of these additional bank loans as collateral by institutions residents in Spain has been very limited. In late March, the loans included in this category accounted for barely 0.24% of the total volume of assets deposited as collateral.

Lastly, measures have also been taken in the context of liquidity support in foreign currency, against a background of bouts of tension in short-term foreign currency funding markets. In November 2011, the Bank of Canada, the Bank of England, the Bank of Japan, the ECB, the Federal Reserve System and the Swiss National Bank announced an agreement to lower the pricing on the existing temporary US dollar liquidity swap arrangements. Further, the authorisation of these swap arrangements was extended to February 2013, and it was agreed to establish temporary bilateral liquidity swap arrangements so that liquidity could be provided in each jurisdiction in any of their currencies where necessary. Against this background, the Eurosystem has continued to regularly conduct liquidity-providing operations in dollars, with maturities of one week and three months, through the fixed-rate tender procedure with full allotment.

1 These operations replaced the longer-term refinancing operation with a maturity of twelve months that had been announced in October 2011.

The difficulties persist in euro area money markets…

The persistence of distrust prompted by the sovereign debt crisis and the additional excess liquidity generated by the new longer-term Eurosystem operations (see Box 2.2) have kept the level of activity on the interbank markets relatively stable, at levels below those recorded in previous years. Chart 2.6.B shows the volume of Eonia trading. It can be seen how, following the notable declines in the middle months of 2011, trading edged up in the final quarter of the year and has remained at similar levels since. In the Spanish interbank market, neither the unsecured segment (the one most affected by the crisis), nor the repo segment saw notable changes during this period.

…resulting in an increase in ECB financing in the context of the two unlimited three-year fixed-rate refinancing operations

The absence of a recovery in the interbank markets and, especially, the provision of additional long-term liquidity by the Eurosystem (two intimately interrelated phenomena) have led to a considerable increase in the overall recourse to Eurosystem liquidity by European deposit institutions. In the specific case of Spanish institutions, this increase in recourse to Eurosystem funds has been more pronounced than for the euro area as a whole, since Spain is one of the countries most affected by the sovereign debt crisis. Chart 2.6.B shows developments in the outstanding amount of funding provided through ECB tenders, both for the Eurosystem as a whole and for institutions resident in Spain. In fact, from end-September 2011 until the second half of April 2012 (a period in which both the two three-year liquidity providing operations were recorded) institutions resident in

Spain increased their gross recourse to the Eurosystem by €236,584 million, while the increase in the outstanding amount of funding for the Eurosystem as a whole amounted to €557,017 million. The increase in funds allotted by the Eurosystem to institutions resident in Spain was concentrated in the new three-year operations, which, apart from generating new demand, displaced most of the amounts that had previously been applied for at shorter maturities (see Chart 2.6.C). Institutions have used these Eurosystem funds to repay large amounts of medium and long-term debt, to reduce funding through central counterparty clearing houses and to acquire highly liquid bonds, placing the surplus in the ECB's deposit facility. In their recourse to Eurosystem financing, the use as collateral by Spanish institutions of bank loans within national frameworks has so far been very limited (0.3%; see Box 2.2).[2]

As a consequence of all this, lending to Spanish institutions has increased as a percentage of total Eurosystem lending

The consequence of the increase in borrowing from the Eurosystem by institutions resident in Spain is that lending to such institutions as a percentage of total Eurosystem lending increased considerably during this period. Chart 2.6.D shows the volume allotted in tenders to institutions resident in Spain relative to total Eurosystem lending. As can be seen, the percentage allotted to institutions resident in Spain has increased with respect to 2011 Q3 levels. In March 2012 the average level was 28%.

Following months of uninterrupted expansion, the deposits of households and non-financial firms in Spain are growing at negative rates …

The deposits of private sector non-financial firms and households resident in Spain raised by Spanish deposit institutions, following months of uninterrupted expansion, have been displaying a downward trend since June 2011. Since October 2011, the rates of change in this variable have been negative (see Chart 2.7.A), which continues to be the case according to the most recent data available (–2.4% in January 2012 relative to January 2011). The slowdown in the rate of growth of retail deposits commenced when the financial tensions associated with the euro area sovereign debt crisis increased. Although these tensions affected the euro area as a whole, they were especially severe in Spain.

…due to a shift in savings to other instruments

Such tensions led to a very sharp increase in the return on public debt, which competes with bank deposits. At the end of 2011, yields on 12-month Treasury bills reached around 5%, although they fell very significantly in first few months of 2012 (to 1.9% in February). The sharp increase in the yield spread between Treasury bills and time deposits (see Chart 2.7.B) makes the former more attractive relative to the latter.

The attractiveness of public debt vis-à-vis bank deposits was also strengthened by the impact of the entry into force of RDL 771/2011, which tends to restrict the interest rates offered by institutions on their deposits.[3] Additional contributions to the Deposit Guarantee Fund are required by those institutions that pay interest on time deposits or current accounts above certain threshold rates.

Against this background of fierce competition for savings, some institutions opted to market other products to attract the savings of non-financial firms and households. In particular, promissory notes, which are not subject to the aforementioned rate restrictions, since they are securities and are not covered by the Deposit Guarantee Fund, have increased sharply in recent months (see Chart 2.7.C), absorbing part of retail deposits. When promissory notes are included, deposits show a more moderate rate of change (see Chart 2.7.D).

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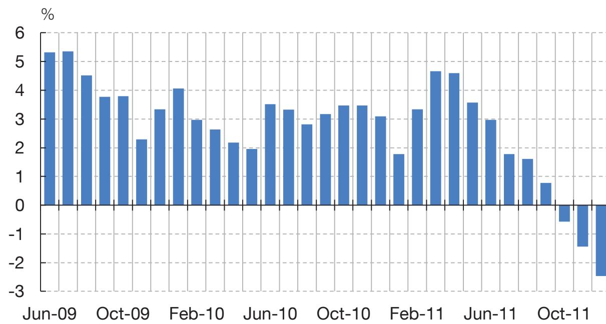
2 Among the measures approved by the ECB in December 2011 is the one that refers to national central banks accepting performing bank loans that satisfy specific eligibility criteria as collateral. Spain, like other countries, approved its national framework in February 2012 (see Box 2.2).

3 RDL 771/2011 links the contributions of institutions to the Deposit Guarantee Fund to the risks they assume.

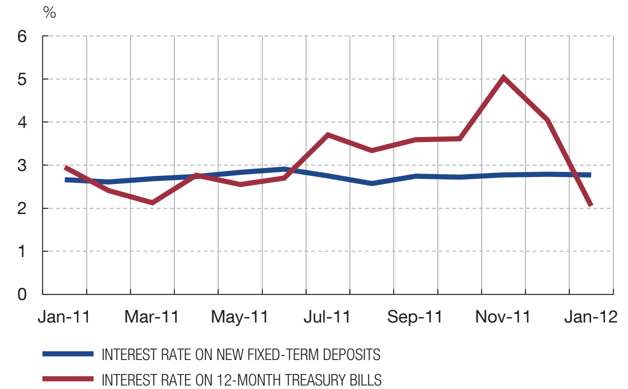
RETAIL FUNDING. BUSINESS IN SPAIN
Deposit institutions, ID

CHART 2.7

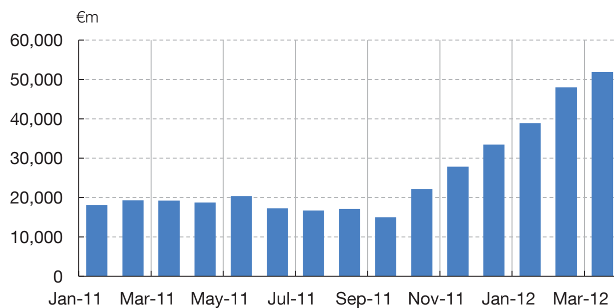
A. YEAR-ON-YEAR RATE OF CHANGE IN NON-FINANCIAL CORPORATIONS´ AND HOUSEHOLDS´ DEPOSITS



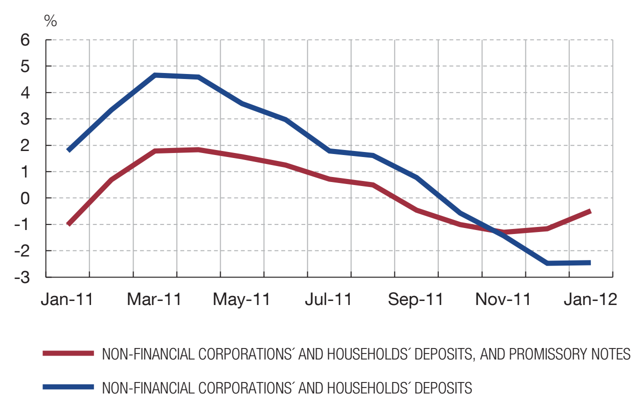
B. WEIGHTED AVERAGE INTEREST RATE ON 12-MONTH TREASURY BILLS AND NEW FIXED-TERM DEPOSITS



C. OUTSTANDING AMOUNT OF PROMISSORY NOTES IN AIAF MARKET. SECURITIES ISSUED BY RESIDENT DEPOSIT INSTITUTIONS



D. NON-FINANCIAL CORPORATIONS´ AND HOUSEHOLDS´ DEPOSITS, AND PROMISSORY NOTES. YEAR-ON-YEAR RATE OF CHANGE



SOURCES: AIAF and Banco de España.

Finally, a further factor that may have partly contributed to the recent decline in retail deposits is the increase in investment in this type of instrument in the rest of the world by the resident private sector, basically firms and, presumably, multinational companies in particular, whose treasury decisions are linked to global group strategies. Between July and December 2011, the volume of this investment was equivalent to around 15% of the decline in the retail deposits held by households and firms with resident credit institutions.

2.1.2 PROFITABILITY

The consolidated net income of Spanish deposit institutions decreased sharply in 2011 compared with 2010

The consolidated profit recorded by the banking sector was 63.5% lower in 2011 than in 2010 (see Table 2.2). The return on assets (ROA) in December 2011 was 0.17%, compared with 0.47% a year earlier. This sharp downward trend was also seen in the return on equity (ROE), which decreased by 5.1 pp to 2.9% between December 2010 and December 2011.

This notable decrease in consolidated income for the year is explained by various factors, the foremost of which are weak net interest income and higher impairment losses. The fall in profit, although across-the-board, differed markedly among institutions, as shown by the dispersion of ROE (see Chart 2.8.A). What is more, the data for the aggregate of deposit institutions, which, as stated above, reflect a decline in profit of 63.5%, include the losses posted by some Spanish institutions in 2011, particularly those incurred by certain institutions in which the FROB had a majority holding.

CONSOLIDATED INCOME STATEMENT
Deposit institutions

TABLE 2.2

	Dec-11		Dec-10	Dec-11
	€m	% Change Jun-11/Jun-10	% ATA	% ATA
Financial revenue	137,249	12.9	3.43	3.76
Financial costs	73,893	32.0	1.58	2.03
Net interest income	63,357	-3.4	1.85	1.74
Return from capital instruments	2,155	-9.8	0.07	0.06
Share of profit or loss of entities accounted for using the equity method	3,617	-2.3	0.10	0.10
Net commissions	23,591	3.9	0.64	0.65
Gains and losses on financial assets and liabilities	6,691	-32.2	0.28	0.18
Other operating income	-1,193	.	-0.01	-0.03
Gross income	98,218	-5.4	2.93	2.69
Operating expenses	50,560	3.9	1.37	1.39
Net operating income	47,658	-13.6	1.56	1.31
Asset impairment losses (specific and general provisions)	29,378	11.4	0.74	0.81
Provisioning expense (net)	3,847	-17.2	0.13	0.11
Operating profit	14,434	-40.2	0.68	0.40
Asset impairment losses (assets other than loans and credits)	11,175	127.6	0.14	0.31
Income from disposals (net)	3,672	4.6	0.10	0.10
Profit before tax	6,930	-69.5	0.64	0.19
Net income	7,732	-58.8	0.53	0.21
MEMORANDUM ITEM				
Income attributable to the controlling entity	6,110	-63.5	0.47	0.17

SOURCE: Banco de España.

The downward pressure on net interest income continues…

Net interest income decreased by 3.4% in 2011 with respect to 2010. In terms of ATA, this represents a drop of 11 bp to 1.74% in December 2011. If the Spanish institutions with a high international presence are excluded from the analysis, the absolute value of net interest income shows a sharper fall (-15.3% year-on-year), as this item also does expressed as a proportion of average total assets (down by 22 bp to 1.06%).

Net interest income continues to come under pressure from various factors, including the downward trend in the spread between the average rates on assets and liabilities, the progressive decline in business volume and the changes in the asset/liability structure. These factors caused financial costs to increase sharply in December 2011 in year-on-year terms (32%), as compared with a more moderate rise in financial revenue (12.9% in the same period).

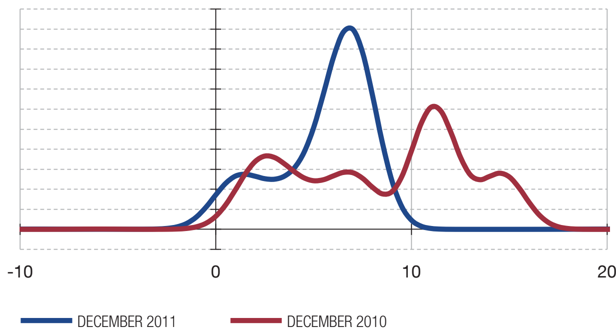
…due to the behaviour of the net interest spread, the weaker activity and the volume of doubtful assets, which earn no interest

The factors exerting downward pressure on net interest income are perceptible in business in Spain. If the change in net interest income is broken down into three factors (changes in yield spread, changes in business volume and changes in asset/liability structure), it is seen that the fall in net interest income between December 2010 and December 2011 is mostly due to a narrowing of the yield spread (see Chart 2.8.B). However, this component lost ground in 2011 relative to 2010 as a factor explaining the decrease in net interest income, since the spread between the average return on assets and the average cost of liabilities steadied during 2011 (see Chart 2.8.C). This development is partly explained by the behaviour of the net interest spread on new business, which,

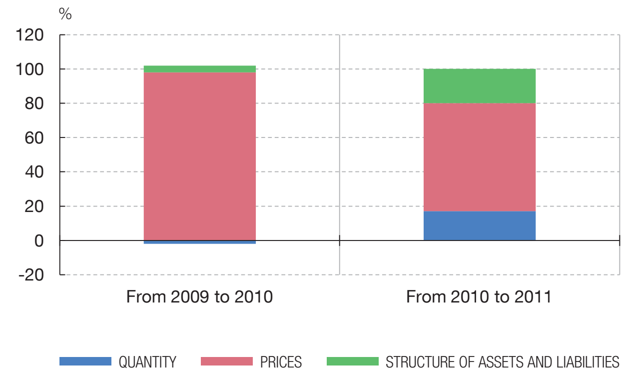
PROFITABILITY
Deposit institutions

CHART 2.8

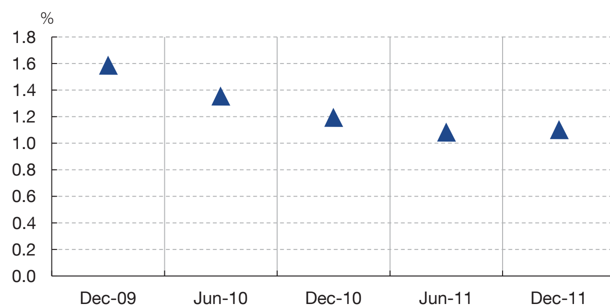
A. DISTRIBUTION OF ATA BY ROE (%)



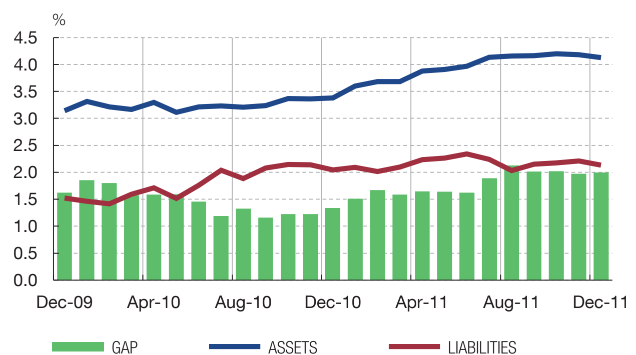
B. PERCENTAGE OF THE DECLINE IN NET INTEREST INCOME EXPLAINED BY EACH FACTOR. BUSINESS IN SPAIN, ID



C. DIFFERENCE BETWEEN AVERAGE RETURN ON INVESTMENTS AND AVERAGE COST OF LIABILITIES. BUSINESS IN SPAIN, ID



D. MARGINAL INTEREST RATES ON ASSETS AND LIABILITIES. BUSINESS IN SPAIN, ID (a)



SOURCE: Banco de España.

a Marginal interest rates are those established in transactions initiated or renewed during the month prior to that of reference, such transactions being weighted by their volume. The assets-weighted marginal rates include, inter alia, those applied to housing and consumer finance and credit to non-financial corporations, while the liabilities-weighted ones include, inter alia, fixed-term deposits and repos.

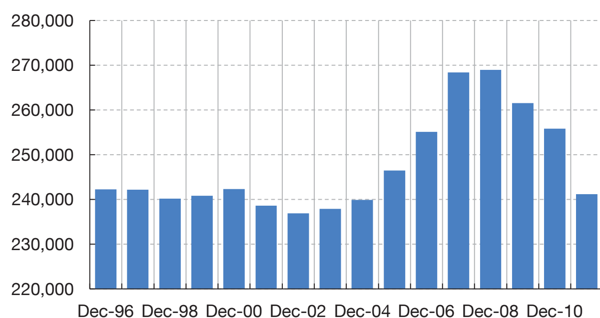
after decreasing until June 2010, subsequently reached a higher level (see Chart 2.8.D). Thus, despite the decrease in net interest income for the overall portfolio, the average spread steadied, and, notably, that on new business has been widening in recent months.

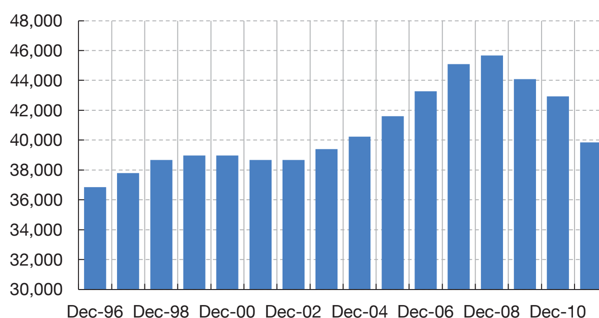
However, although the measures adopted by the ECB have helped to alleviate medium- and long-term euro area financial market tensions, it cannot be ruled out that in the coming quarters net interest income may come under downward pressure due to developments in financial costs. The other two factors contributing (to very similar extents) to the fall in net interest income in business in Spain between 2010 and 2011 are falls in business volume and negative effects on the asset/liability structure.

Commissions increased by 3.9% in 2011 compared with December 2010. The various components of commission revenue grew commensurately, although the total is basically explained by those relating to collection and payment services and by the marketing of non-bank financial products, due to their greater relative importance within total commissions. In any event, the increase in commissions, and the slight rise in the profits of entities accounted for using the equity method did not offset the fall in return on equity instruments (–9.8%) and in gains on financial transactions (–32.2%). Accordingly, gross income decreased by 5.4% year-on-year (24 bp in terms of ATA, to 2.7%).

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

CHART 2.9





SOURCE: Banco de España.

Operating expenses moderated…

Operating expenses grew by 3.9% in December 2011 with respect to the same period of the previous year. This increase is seen both in personnel expenses (up 3.9% in December 2011 year-on-year) and in administrative expenses (up 4.9%), while depreciation and amortisation expenses remained practically unchanged. This increase in operating expenses, along with the fall in gross income, meant that the efficiency ratio worsened from 46.9% in December 2010 to 51.5% in December 2011.

…and the number of bank offices and employees in Spain continued to decline

In total business at consolidated level, the behaviour of operating expenses is strongly affected by the Spanish institutions with a higher presence abroad, both because they have changed their scope of consolidation to some extent and because their investment process is not uniform across the different geographical areas. Excluding from our analysis the institutions with a larger international presence, operating expenses decreased by 3.8% between December 2010 and December 2011. This is consistent with the progressive reduction of employees and offices in business in Spain from the peaks reached in mid-2008 (see Charts 2.9.A and 2.9.B). In any event, given that these institutions suffered the most severe contraction of gross income, in line with the higher fall in net interest income, their efficiency ratio worsened much more sharply, deteriorating from 52.6% in December 2010 to 61.5% in December 2011.

Asset impairment losses grew…

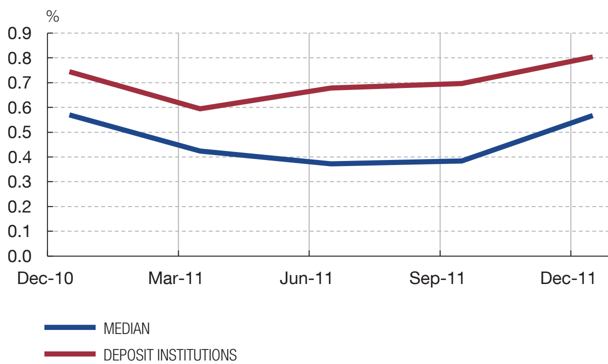
Asset impairment losses, which reflect specific and general provisions, grew by 11.4% in December 2011 with respect to December 2010. This increase in impairment losses in 2011 is also apparent in terms of average total assets, with a rise from 0.6% in the first quarter of the year to 0.8% in December (see Chart 2.10.A). This development stems from a number of factors, some of which are of an individual nature in that they are due to large increases in this item at specific institutions, some of whose impairment losses jumped significantly in the past quarter, owing partly to early application of subsequent regulatory changes. Others are more general, since there was a relatively widespread rise among institutions, particularly in the fourth quarter of 2011, as a result of the aforementioned worsening in doubtful assets and of a possible step-up in the recognition of real estate portfolio impairment. The fact that the general trend is upward in 2011 Q4 is reflected in the behaviour of the median of the ratio of impairment losses to average total assets, while the individual situations of institutions have been putting upward pressure on this ratio for the sector as a whole (see Chart 2.10.A).

Other impairment losses, i.e. for assets other than loans and receivables, grew much more sharply in 2011 with respect to the same period of 2010 (128%). This is due, firstly, to the

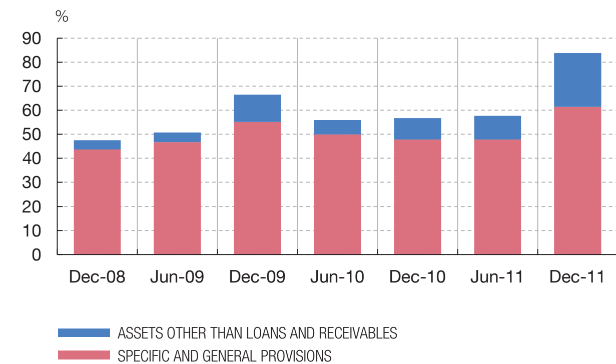
ASSET IMPAIRMENT LOSSES

CHART 2.10

A. ASSET IMPAIRMENT LOSSES (SPECIFIC AND GENERAL PROVISIONS) AS A PERCENTAGE OF ATA



B. ASSET IMPAIRMENT LOSSES AS A PERCENTAGE OF NET OPERATING INCOME

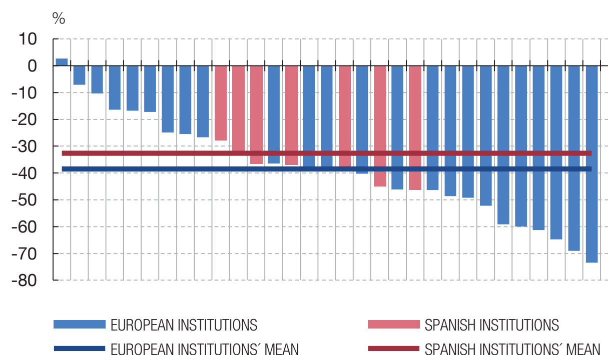


SOURCE: Banco de España.

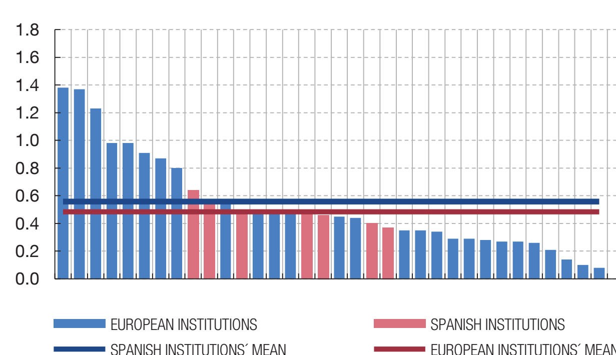
MARKET INFORMATION
International comparison

CHART 2.11

A. STOCK MARKET FALL BETWEEN 30 JUNE 2011 AND 19 APRIL 2012 (a)



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



SOURCE: Datastream.

a Each bar represents an institution. Latest data: 19 April 2012.

higher provisions associated with foreclosures, a phenomenon extending to all institutions but particularly marked in certain ones, and, secondly, to goodwill impairment at some foreign subsidiaries of Spanish institutions.

…and reduced operating income by a considerable percentage

In any event, impairment losses, whether they be on loans and receivables or on other types of assets, and even taking into account that the December 2011 figure reflects upward influence from the individual situations of certain institutions, show a growing trend which is progressively eroding an increasingly large percentage of institutions' operating income (see Chart 2.10.B), which in turn is subject to downward pressure from the aforementioned factors acting on net interest income. It cannot be ruled out that 2012 will see an increase in impairment losses, due to the behaviour of doubtful assets in the current economic setting and to the application of Royal Decree-Law 2/2012.

As a result of all the above, profit before tax decreased by 69.5% between December 2010 and December 2011 to €7,732 million in December 2011 (see Table 2.2). Twenty consolidated groups posted losses totalling somewhat more than €8,170 million. The tax effects of these losses, taken together with others at the consolidated groups posting

profits (91 groups), gave rise to accrued corporate income tax for accounting purposes of the total consolidated groups for 2011 as a whole which resulted in €800 million higher profit after tax than before tax.

The market-to-book value of European institutions is under strong downward pressure, with Spanish institutions standing in an intermediate position

The financial tensions in 2011, along with the misgivings about the situation of financial institutions in a weaker macroeconomic setting, led to a fall in their stock market prices (see Chart 2.11.A). Nevertheless, Spanish institutions occupy an intermediate position with respect to comparable European institutions.

Comparison of the stock market value of institutions with their book value shows that, save some exceptions (basically Nordic and Swiss institutions), the main European institutions are subject to notable pressure (see Chart 2.11.B). Spanish institutions are in an intermediate situation, although they exhibit a certain heterogeneity, derived partly from their business model and partly from the quality of their assets.

2.1.3 SOLVENCY

The solvency ratio increased…

The **solvency ratio** of Spanish deposit institutions ended the year with a gain of 57 bp, standing at 12.4% at end-2011 (see Chart 2.12.A). In twelve months the tier 1 ratio rose from 9.6% to 10.6%. The rise in solvency ratios was concentrated in the increase in higher-quality capital. Royal Decree-Law 2/2011, enacted in February 2011, raised capital requirements for institutions in two ways: creating a new own funds requirement based on *capital principal* (hereafter referred to as "core capital", since it is similar to core capital as defined in Basel III for application in 2013), and raising capital levels to 8% for all institutions and, in certain cases, to 10%. Royal Decree-Law 2/2011 specified that these capital levels had to be reached by 30 September 2011. In December 2011, according to the first disclosure by deposit institutions under the new regulation, this core capital ratio stood at 9.8%, although it varied somewhat across institutions (see Chart 2.12.B).

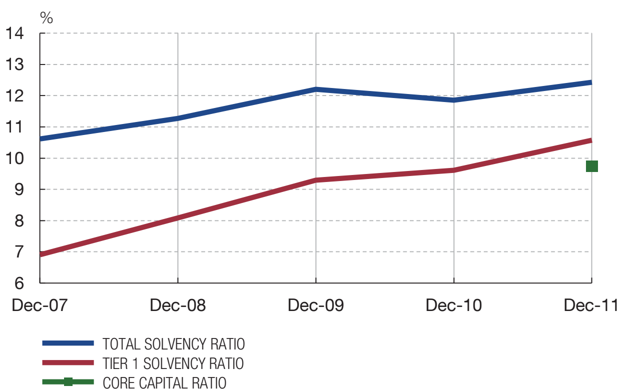
…because of the rise in higher quality capital

Total own funds decreased by 0.19% year-on-year in 2011, 3.5 pp more than the change in 2010. The more severe core capital requirements accelerated the expansion of tier 1 capital, the growth of which, at 4.1%, was higher than the rate of 3.6% in the previous year. This strengthening of capital took place at the expense of lower quality capital, which decreased by 19.3% on top of the fall of 17.1% in 2010.

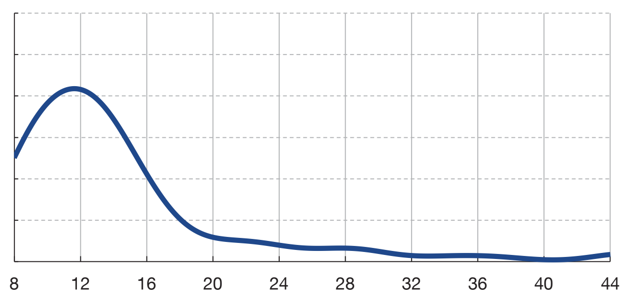
SOLVENCY
Deposit institutions

CHART 2.12

A. TOTAL AND TIER 1 SOLVENCY RATIOS AND CORE CAPITAL RATIO



B. DISTRIBUTION OF INSTITUTIONS ACCORDING TO CORE CAPITAL RATIO (%) (a)



SOURCE: Banco de España.

a Non-parametric estimation of the density function, which provides a continuous and smoothed graphic representation of such function. As it is based on the number of institutions, they all have the same weight in the distribution without the larger ones having a heavier weighting. A shift rightwards in the distribution denotes an improvement in solvency.

CAPITAL REQUIREMENTS AND OWN FUNDS
Deposit institutions

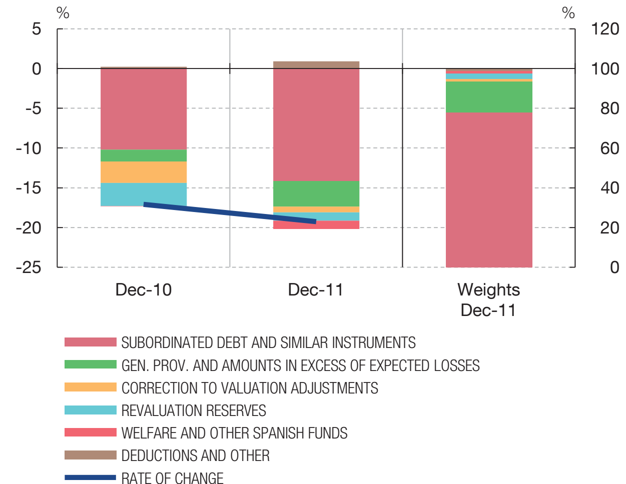
CHART 2.13

A. REQUIREMENTS. CONTRIBUTION TO RATE OF CHANGE AND COMPOSITION (right-hand scale)

B. OWN FUNDS. CONTRIBUTION TO RATE OF CHANGE AND COMPOSITION (right-hand scale)

C. TIER 1 CAPITAL. CONTRIBUTION TO RATE OF CHANGE AND COMPOSITION (right-hand scale)

D. TIER 2 CAPITAL. CONTRIBUTION TO RATE OF CHANGE AND COMPOSITION (right-hand scale)



SOURCE: Banco de España.

Under the more exacting requirements for higher quality capital stemming from Royal Decree-Law 2/2011, tier 1 capital has continued to grow as a result of the higher capital (24.6%). Meanwhile, intangible assets decelerated, although they continued to grow at a rate of 4.3% (see Chart 2.13.C).

Tier 2 capital fell further, showing a decline of 19.3% as all its components contracted (see Chart 2.13.D). Most notable in this respect is subordinated debt (the largest component of tier 2 capital with a weight of 78%), which decreased by 18.4% at a time when markets and regulators/supervisors are focussing on higher quality capital, for which subordinated debt is not eligible. Meanwhile, the general provisions eligible to be counted as own funds (with a weight of 16%) fell by 20.2% because they shrank as a result of the ongoing rise in specific provisions.

Spanish institutions have leverage levels below those of their European peers

As a result of the European Banking Authority's recapitalisation scheme agreed at the summit of euro area Heads of State or Government on 26 October 2011, institutions will have to hold a temporary capital buffer, which will derive from two sources. First, the

SOLVENCY OF THE BIGGEST EUROPEAN BANKS (a) CHART 2.14

A. RWA AS A PERCENTAGE OF TOTAL ASSETS. DECEMBER 2011

B. SHAREHOLDERS' EQUITY AS A PERCENTAGE OF TOTAL ASSETS. DECEMBER 2011

SOURCE: Financial reports of the banks in question.

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

marking-to-market of government debt instruments; and second, the raising of the minimum capital requirement to a core tier 1 level of 9%, in accordance with the definition adopted by the EBA. Five Spanish institutions participated in this exercise. They were found to need capital of €26 bn, which has to be provided by 30 June 2012. These requirements arise largely from applying the EBA's definition, which disregards national specificities as it seeks a standard definition for all countries. At present, Spanish institutions have covered all these additional capital needs derived from the EBA exercise.

The solvency position of institutions depends also on the denominator of the ratio, i.e. on risk-weighted assets. An intense debate is currently under way in this respect and various international teams within the Basel Committee on Banking Supervision and the EBA are working to analyse the differences between institutions in the different countries and reach a consensus on standardisation (see Charts 2.14.A and 2.14.B).

2.2 OTHER FINANCIAL MARKET PARTICIPANTS

Life insurance premiums grew and non-life premiums decreased slightly

Spanish insurance companies recorded an increase of 4.13%[4] in the volume of premiums issued in 2011 with respect to 2010. This growth in premiums for the sector as a whole masks uneven performances by the life segment, where they grew by 9.5%, and the non-life segment, where they decreased by 0.28%. Within the non-life segment, performance was also uneven across the various types of insurance, although generally the more expansionary lines were not as buoyant as the life segment. Thus, the volume of premiums increased by 3.34% in multirisk insurance and by 3% in health insurance. By contrast,

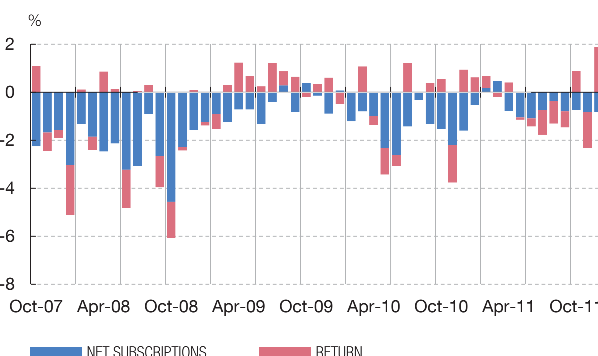
4 ICEA data.

INVESTMENT AND PENSION FUNDS

CHART 2.15

A. ASSETS OF INVESTMENT FUNDS AND PENSION FUNDS

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



SOURCES: INVERCO and Banco de España.

the business volume of automobile insurance declined (premiums down by 2.3%), as did that of the other non-life lines (–3%).

The solvency margin of the sector as a whole amply exceeds the legal minimum

From the standpoint of the solvency of the insurance sector as a whole, the data relating to December 2011 show that the solvency margin is slightly over 260%, i.e. around 2.6 times the legal minimum. Segmental analysis shows that the solvency margin is significantly higher in the non-life segment (353%) than in the life segment (189%).

Various sources of risk persist in the European insurance sector and are present to varying extents in Spanish companies

The European insurance sector faces different risk factors which put pressure on its profitability and solvency. These factors are also apparent to varying extents in Spanish companies, depending on their characteristics. The insurance segments hardest hit by the adverse macroeconomic situation are those whose results or business volume depend most on the business cycle.

The insurance sector is also unfavourably affected by the strain in the financial markets, particularly that relating to sovereign debt, which insurance companies hold on their balance sheets.

Regarding the financial market situation, the prolonged period of low interest rates also adds to the pressure on insurance companies. This risk is higher insofar as the maturities of assets and liabilities are less well matched.

The downward pressure on investment fund assets continues

The tension and uncertainty in financial markets, plus the intense competition of investment funds with other savings products of a bank (e.g. deposits and promissory notes) or non-bank (e.g. Treasury bills) nature, has led to a progressive loss of investment fund assets (see Chart 2.15.A). This is seen in the adverse trend in net subscriptions (negative from 2011 Q2), which has been only partly offset by sporadic gains in yields in some months. Meanwhile, pension funds show greater stability in their assets, as would be expected given their nature (see Chart 2.15.B).

The international financial crisis has shown the need for improving, among other things, different aspects of credit institution regulation and supervision. This chapter of the FSR analyses two topics in this respect. First, from a more global perspective, it looks at the necessary process of convergence in accounting legislation between the US and the EU; and second, within the confines of Europe, the work of the European Systemic Risk Board (ESRB) in macro-prudential regulation and supervision.

International accounting convergence

The crisis highlights the importance of a single accounting framework…

Since the onset of the crisis the G-20 has reiterated the importance of a single high-quality accounting framework for the capital markets, and put special emphasis on the convergence between international accounting standards (IFRS) and US standards (US GAAP).

… and, in particular, the convergence of international accounting standards with US standards

Worldwide, more than 100 countries apply IFRS. Nevertheless, convergence with the US accounting regulator is of particular importance. Since 2002 (Norwalk Agreement), both regulators have been working on a process of convergence which has reduced the differences between them, most notably in the areas of consolidation, fair value and post-retirement employee benefits.

In 2010 the SEC made public its intention of considering the adoption of IFRS for US issuers. International companies listed on US markets can apply IFRS, just as companies listed in the EU can apply US GAAP. In May 2011 the SEC published various alternatives for the adoption of IRFS in the US: full direct application of IFRS or use of IFRS with some kind of approval process which might entail changes to the original standards. Most countries, including those of the EU, apply IFRS in this second way. In any case, the risk is that the SEC may end up adopting IFRS (principles) while at the same time retaining its guide lines (rules).

The final decision of the SEC on the adoption of IFRS has been postponed for the time being, and the conclusions reached to date are not definitive. Among other reasons, the SEC has emphasised the differing approaches of the two regulators involved: the FASB (US) with its detailed financial information regulation system characterised by sector-specific rules, as compared with the principles-based approach of the IASB (international) which does not have sector-specific rules but rather rules consistent with a broad conceptual framework.

Differences persist in various areas…

Despite the efforts made, differences continue to exist between the FASB and the IASB, even in matters already revised by both of them. The differences in the banking sector are several.

There are various differences in the area of financial instruments, but both regulators are currently working to reduce them, so they may converge substantially in significant matters such as classification and measurement and the calculation of impairment. There are certain differences in the area of hedging, since under IFRS it is easier to use interest rate risk hedge accounting for both closed and open portfolios. This may be important for institutions which actively manage their interest rate risk. As regards the netting of assets and liabilities, the two regulators have agreed to maintain the differences and converge in reporting requirements. This matter is important in that it may give rise to differences in balance sheet size and hence affect certain matters such as the leverage ratio.

Another significant difference arises in sale and lease back transactions in fixed assets. The treatment of these transactions under US GAAP hinders asset derecognition, giving rise to the deferral of P&L compared with IFRS.

A minor difference which does not affect valuation so much as balance sheet disclosure is the recognition of software. Software is classified as a fixed asset under US GAAP and as an intangible under IFRS. This difference would be insignificant if capital regulation standards recognised intangibles as assets, but they do not.

Goodwill impairment may also lead to significant differences. Under IFRS goodwill impairment is estimated on the basis of recoverable value, while under US GAAP it is measured using fair value, as if a new business combination were involved.

…although the regulators continue to cooperate

In any event, the cooperation between the accounting regulators continues and various joint projects are under way with the aim of achieving greater convergence between the two sets of standards. Efforts are currently focusing on accounting for financial instruments and finance leases and on revenue recognition.

Recent activity of the European Systemic Risk Board

The aim of the European Systemic Risk Board is to mitigate or prevent systemic risks which may jeopardise the stability of the EU financial system

The European Systemic Risk Board works to mitigate or prevent systemic risks which may jeopardise the stability of the EU financial system.[1] By contrast, it has no direct competence in the area of crisis management and resolution. Therefore, the fact that this institution commenced operations in the thick of the economic crisis meant that it had to make a considerable effort to find a reasonable balance between its concern about materialised or imminent risks and its duty to carry out the medium- and long-term tasks at the core of its mandate.

Since it commenced operations in January 2011, the ESRB has carried out various tasks ranging from analysis for detecting and prioritising potential risks to the issuance of warnings and recommendations

Since it began operating in January 2011, the ESRB has been active in various areas, including the following: assessment of the macro-prudential implications of the current crisis; analysis aimed at detecting and prioritising potential medium- and long-term risks; development of a well-defined system of analytical tools, policy instruments and institutional frameworks appropriate for putting into practice effective macro-prudential policies; and, most notably, the adoption of decisions on the use of its main instruments (warnings and recommendations)[2] to signal and address potential risks to EU financial stability.

The ESRB has recently highlighted various vulnerabilities…

The ESRB's most recent diagnosis of the main vulnerabilities of the EU financial system[3] pointed to a certain improvement in the financial market situation compared with the second half of 2011. It largely attributed this to the adoption of exceptional liquidity providing measures by the central banks (particularly the ECB tenders with full allotment for three-year maturities), to the European agreements on public finances reached in December and to the progress of various countries in fiscal consolidation and structural reforms. This improvement has been reflected particularly in the moderation of the short-term tensions associated with the difficulties of the banking sector in raising funds on the wholesale markets. However, the ESRB stresses that the uncertainty is still very high and there are

1 For an in-depth review of the structure, objectives and instruments of the ESRB, see Chapter 3 "The European Systemic Risk Board and macro-prudential oversight in Europe" of the November 2011 Financial Stability Report.
2 The ESRB's policy tools are warnings and recommendations (which may in turn be public or confidential). Warnings call attention to potential risks to financial stability (without specifying specific action), whereas recommendations prescribe specific measures to address risks and set a schedule for applying them.
3 The latest meeting of the ESRB General Board was on 22 March 2011.

still significant risks derived from the potential negative interplay between various closely interrelated factors, such as i) the persistent misgivings about the sovereign debt of some euro area countries; ii) the pressure on private funding of the banking sector and the deleveraging of this sector (which in many cases is a natural correction of past excesses, but should not be done in a way that affects the supply of credit); and iii) the considerable downward revision of economic growth prospects.

Against this backdrop, the ESRB considered it important that governments should maintain their commitment to fiscal objectives and to structural reforms for boosting growth and that banks should take advantage of the recent relaxation of market tensions to continue strengthening their balance sheets and reduce their dependence on central bank measures to provide financing. Also, the ESRB emphasised the recent fall in cross-border financial activity, including within the euro area, as a result of which it has called on all public and private institutions to make an effort to safeguard the integrity of the Single Market. Lastly, the ESRB has indicated that, in addition to the risks already mentioned, it will examine more thoroughly the impact of the current economic weakness on credit risk and, in particular, on the effects of forbearance (changes in the contractual terms and conditions of potentially troubled loans), and that it will monitor the potential impact of the current conditions of high liquidity on risk aversion.

…and made three public recommendations: on the risks derived from lending in foreign currencies; …

So far the ESRB's work to assess the potential risks to EU financial stability has resulted in three public recommendations.[4] The first, published in October 2011, focuses on the risks which may derive from lending in foreign currencies; while the other two, published in January 2012, relate to the risks associated with the dependence of certain EU financial institutions on US dollar denominated funding and the need for national macro-prudential authorities to have strong mandates.

The first recommendation is on lending in foreign currencies to households and firms (mainly SMEs) which do not have adequate protection against foreign exchange risk.[5] This lending exposes borrowers to foreign exchange market fluctuations, may give rise to significant credit and funding risks in the banking sector and, to the extent that it usually proliferates when interest rates are low, may contribute to excessive growth of credit in the overall economy. To prevent or mitigate these risks, the ESRB has proposed an extensive set of measures designed to achieve the following: raise borrowers' awareness of the risks involved; ensure that these loans are only granted to sufficiently solvent borrowers; appropriately include the risks associated with this activity in credit institutions' internal control systems; adopt more stringent capital requirements for loans of this type; monitor and limit the liquidity risks associated with this lending; and, finally, ensure reciprocity in the prudential measures adopted in this area, thereby impeding regulatory arbitrage.

…on US dollar denominated funding of a significant portion of the EU banking system; …

The second recommendation is on the risks derived from US dollar denominated funding of a significant portion of the EU banking system. Most of the funding in this currency is short term and obtained from other banks and financial institutions, which contributes to its volatility. During the latest financial crisis, there have been major tensions in the financial markets for this currency, the systemic effects of which could have been significant. To avoid a recurrence of similar levels of tension in the future, the ESRB has issued two recommendations to national banking supervisors so they closely monitor US dollar

4 The documentation relating to these recommendations is available at the following website: http://www.esrb.europa.eu/recommendations/html/index.en.html.

5 In recent years, this type of loan has proliferated considerably in some EU countries, particularly in Eastern Europe.

funding and liquidity risks and limit them if they reach excessive levels. Also, national supervisors are recommended to ensure that banks are ready to withstand potential shocks in US dollar funding and have contingency plans which expressly address this risk.

…and on the macro-prudential mandate of national authorities

Lastly, the ESRB's third recommendation focuses on the macro-prudential mandate of national authorities. This recommendation considers that, for macro-prudential policies to be effective in the EU, it is essential to designate national authorities with well-defined mandates, powers and instruments, taking into account also that the ESRB cannot directly use macro-prudential instruments and that its recommendations are not binding. The recommendation clearly sets out five principles which should be followed to ensure that the design of these mandates is effective:

1. A macro-prudential authority should be expressly designated with the mandate of safeguarding financial stability.

2. The specific characteristics of this authority may vary depending on each country's traditions and institutional structure, although it is emphasised that, in any event, central banks should play a leading role, given their functions and capabilities in the areas of macroeconomic analysis and financial stability.

3. These authorities should have the information and instruments they need to identify and attempt to mitigate risks to financial stability.

4. Governance requirements based on transparency and accountability should be established.

5. The macro-prudential authority should be independent to ensure that it is shielded against pressures from private groups or political interests.

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