

**FINANCIAL STABILITY
REPORT**

11/2014

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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
BRRD	Bank Recovery and Resolution Directive
CBE	Banco de España Circular
CBSO	Banco de España Central Balance Sheet Data Office
CCB	Countercyclical capital buffer
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
CET1	Common equity Tier 1 capital
CIs	Credit institutions
CNMV	Comisión Nacional del Mercado de Valores (National Securities Market Commission)
CPSS	Basel Committee on Payment and Settlement Systems
DIs	Deposit institutions
EAD	Exposure at default
EBA	European Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
EONIA	Euro overnight index average
EPA	Official Spanish Labour Force Survey
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
FASB	Financial Accounting Standards Board
FROB	Fund for the Orderly Restructuring of the Banking Sector
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSR	Financial Stability Report
FVC	Financial vehicle corporation
GAAP	Generally Accepted Accounting Principles
GDI	Gross disposable income
GDP	Gross domestic product
G-SIIs	Global systemically important institutions
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
JST	Joint Supervisory Team
LGD	Loss given default
LTROs	Longer-term refinancing operations
LTV	Loan-to-value ratio (amount lent divided by the appraised value of the real estate used as collateral)
m	Millions

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

MiFID	Markets in Financial Instruments Directive
MMFs	Money market funds
NPISHs	Non-profit institutions serving households
NPLs	Non-performing loans
OMT	Outright Monetary Transactions
OTC	Over the counter
PD	Probability of default
PER	Price earnings ratio
pp	Percentage points
RDL	Royal Decree-Law
ROA	Return on assets
ROE	Return on equity
RWA	Risk-weighted assets
SCIs	Specialised credit institutions
SMEs	Small and medium-sized enterprises
SIV	Structured investment vehicle
SPV	Special purpose vehicle
SSM	Single Supervisory Mechanism
TA	Total assets
TARP	Troubled Asset Relief Program
TLTROs	Targeted Longer-term Refinancing Operations
VaR	Value at risk
WTO	World Trade Organisation

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OVERVIEW

Since the publication of the last *Financial Stability Report (FSR)*, the climate of stability on international financial markets observed in previous quarters has prevailed for most of the period, in tandem with further reductions in financing costs, more sharply so in the euro area. This pattern has not, however, been free from certain bouts of tension, such as that in mid-October, which was linked to fears over economic growth globally and, especially, in the euro area. This episode translated into losses across the board in stock market indices and rises in risk premia and in volatility.

In Spain, 10-year government bond yields stood at 2.1% in end-October, which saw the spread relative to German government debt narrow to 125 basis points (bp) in this same period. The improved conditions on domestic wholesale markets have been accompanied by more buoyant GDP, which is translating into an incipient pick-up in employment and some strengthening of the economic and financial position of households and non-financial corporations.

Against this backdrop, the rate of decline of lending to the resident private sector has stabilised over the past year. And the pace of the decline in lending to households and to non-financial corporations has eased in recent months. This aggregate trend will continue to be influenced by the need to correct high private-sector debt, especially in construction and real estate-related activities, where the contraction in credit has been greater than in the other sectors.

For the first time, this FSR shows the structure of lending to corporations, accurately separating lending to large corporations from that to SMEs and their different components. Information is also offered on Spanish banks' new credit, although the related year-on-year trend cannot yet be shown.

The year-on-year rate of increase in the total volume of NPLs to the resident private sector has eased in recent months, having posted month-on-month declines from January 2014 to the latest available data for the current year. This moderation in the pace of NPLs is particularly discernible for non-financial corporations and for lending to households for house purchase. The NPL ratio, despite posting higher levels than those observed last year, has dipped slightly from the levels attained towards late 2013 and 2014 Q1. This fall is the result of declines in NPLs in the year to date, largely offset by the downward course of lending (the denominator of the ratio).

The prevailing climate of stability on financial markets has been evident in the continuing low levels of the systemic risk indicators for Spain. Retail funding from the deposits of households and non-financial corporations shows a stable trend which, combined with the contraction in credit, provides for a narrowing of the retail sector funding gap.

In the first half of 2014 the Spanish banking sector posted a consolidated result of almost €8 billion, slightly down on the same period a year earlier. Net interest income declined, essentially as a result of the reduction in the volume of activity and of a still-high level of assets not generating a return. Gains on financial transactions also fell, thereby shrinking gross income. These factors, which exerted downward pressure on results, were offset positively by the decline in operating expenses, the outcome of the reduction in the number of employees and offices, and by lower asset impairment losses.

The year 2014 saw the roll-out of the new EU prudential regulations, which transpose the solvency standards known as Basel III to the European regulatory framework. Under Basel III, Spanish banks as a whole showed a CET1 ratio of 11.6% in June 2014. The respective metrics for CET1, total capital and Tier 1 capital all comfortably exceed the regulatory minimum levels in Basel III.

In sum, the rate of decline of aggregate bank lending in Spain has shown signs of easing, both for households and for non-financial corporations. There has, moreover, been a discernible slowdown in the rate of increase in NPLs in these sectors, while their NPL ratios show slight declines in the latest data for 2014 compared with those for end-2013 and for 2014 Q1. Whether these trends continue and intensify will largely depend on how the Spanish economy fares. Currently, the economy is in a phase of incipient recovery which, under the most likely economic scenario, will take root; however, this scenario is not free from certain risks linked to factors both external (the performance of the global economy and, in particular, that of the euro area) and internal (linked to the need to see through the correction of certain imbalances).

The comprehensive assessment exercise conducted by the ECB, whose results were made known on 26 October, allows for evaluation of the quality of public financial information and of the impact of an adverse scenario, with a very low probability of occurrence, on the loss-absorbing capacity of the participating banks. The results show that no Spanish bank would today have a capital shortfall taking as a reference the thresholds defined in the exercise. As analysed in detail in this Report, the AQR exercise shows that the adjustments required in Spain to banks' capital as at end-year 2013 are the lowest among the Single Supervisory Mechanism (SSM) members. Further, the impact of the adverse scenario on Spain would be far less than the average for the banks participating in the exercise. Accordingly, the exercise reveals that Spanish banks' balance sheets offer a rigorous view of asset values and that their resilience in the face of adverse scenarios would be relatively high.

In the "Other matters" section, recent developments in different international fora are presented. First, the latest work by the European Systemic Risk Board (ESRB) on the use of the countercyclical capital buffer is covered. Second, recent initiatives by the Financial Stability Board (FSB) in connection with shadow banking are addressed. And third, the main proposals by international organisations regarding international accounting standards are set out.

Notably, two boxes are included. The first offers an analysis of the distribution of resolution competences in SSM Member States. Broadly, the possibilities range from placing national resolution authorities under the same roof as the national supervisory authority to creating independent national authorities, with intermediate arrangements involving different distributions of functions between respective independent resolution and prudential supervision authorities. As set out in the Box, each of the models has advantages and disadvantages, although all the SSM countries, with the exception of Finland, are opting to place the resolution authority under the roof of the authority with supervisory powers.

Finally, the second Box describes different aspects of the SSM and the organisational changes at the ECB and the Banco de España to address the needs arising as from 4 November this year on the entry into force of the SSM and the assumption of direct supervisory responsibilities by the ECB.

1 MACROECONOMIC RISKS AND FINANCIAL MARKETS

The climate of stability on international financial markets has prevailed for most of the period, against a background of abundant global liquidity and growing differences between the monetary policies of the main advanced economies. But the developments described have not been free from certain episodes of tension, as was the case in mid-October

In the euro area, sovereign debt yields and risk premia on bonds issued by the private sector fell. In the United States and the United Kingdom, long-term interest rates declined more moderately. The performance of stock market indices differed from one area to another and the dollar appreciated against the main currencies

The pattern described has been accompanied by growing concern over the latest developments in certain international financial markets which might have implications for future financial conditions

Global economic activity slowed during the first half of 2014 owing to negative surprises in advanced economies...

Since the publication of the last *Financial Stability Report*, the climate of stability on international financial markets observed in previous months has prevailed for most of the period, against a background marked by the search for yield by investors, abundant global liquidity and growing differences in the monetary policies of the main advanced economies. Thus, whereas rises in official interest rates are anticipated in the United States and the United Kingdom, Japan and the euro area remain in the midst of a phase of monetary expansion. At its meetings in June and September, the ECB Governing Council adopted a broad package of monetary easing measures, conventional and non-conventional alike, in order to combat the risks associated with a scenario of low inflation over a prolonged period.¹ Market developments have not, however, been free from the occasional episode of tension. One such instance was in early August, in connection mainly with the geopolitical conflict in Ukraine. Another was in mid-October, linked to fears over economic growth globally and, in particular, in the euro area, which translated into losses across the board in stock market indices and rises in risk premia and in volatility.

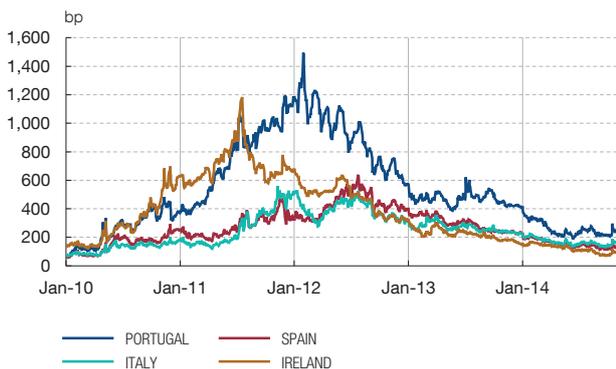
Against this background, there was a fairly generalised decline over the past six months in sovereign debt yields in the euro area to historically low levels (see Charts 1.1.A and B). In particular, in the case of Spanish ten-year bonds, yields dipped from 3% at end-April to 2.1% in end-October, with the spread relative to the German Bund narrowing from 155 bp to 125 bp over the same period. Average credit risk premia also fell on fixed-income securities issued by European financial and non-financial corporations (see Chart 1.1.C), standing at their lowest levels since late 2007. In the United States and the United Kingdom, long-term debt yields also fell, albeit less markedly. The performance of stock market indices differed from one area to another, with moderate declines in the euro area and rises in the United States (see Chart 1.1.D). The dollar, for its part, tended to appreciate against the main currencies.

The pattern described has been accompanied by growing concern over the latest developments in certain international financial markets which might have implications for future financial conditions. In particular, investors' greater readiness to assume risks, assisted by plentiful global liquidity, has contributed to taking credit spreads on the high-risk segments, such as high-yield bonds, to historically low levels. In parallel, issues of these latter assets have been notably buoyant in some areas, meaning that the weight of these instruments in investor portfolios has risen, increasing the impact a potential price correction would entail, which might, moreover, be exacerbated by the low liquidity of the markets on which some of these assets are traded.

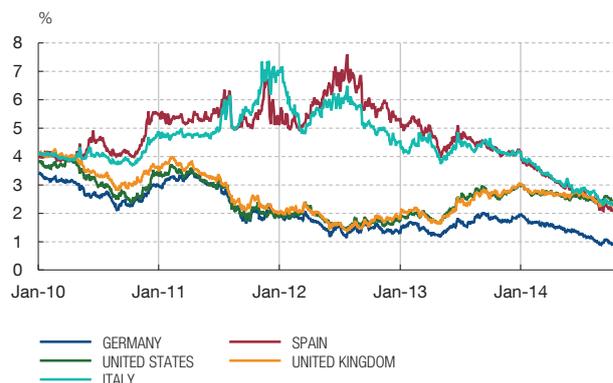
In the first half of 2014, growth in the global economy was lower than expected. This pattern was apparent in the advanced and emerging economies alike. Among the former, there was a notable contraction in GDP in the United States in Q1 as a result of temporary factors (particularly harsh weather and a marked decline in inventories), although the economy rebounded appreciably in Q2 and is expected to grow at a rate close to 3% in the second half of the year. In Japan, in Q2, the impact on activity of the rise in consumption tax was somewhat greater than anticipated. In the euro area, following four quarters of

¹ Box 2.3 in this FSR sets out the ECB's new non-conventional measures. For greater details on the ECB's measures, see the "Quarterly report on the Spanish economy" section in the July 2014 and October 2014 editions of the Banco de España's *Economic Bulletin*.

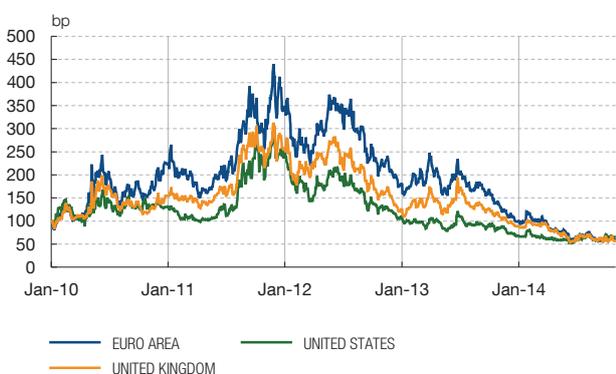
A. TEN-YEAR GOVERNMENT BOND YIELDS: SPREAD OVER GERMANY



B. TEN-YEAR GOVERNMENT BOND YIELDS



C. FINANCIAL SECTOR CREDIT RISK INDICES (a)



D. STOCK EXCHANGE INDICES



SOURCES: Datastream, Reuters and Bloomberg.

a Euro area: 5-year iTraxx Europe Senior Financials. United States and United Kingdom: average 5-year CDS for commercial banks. Latest data: 29 October 2014.

moderate growth, GDP was flat in Q2 compared with Q1 (see Chart 1.2.A). This performance was partly influenced by temporary factors but was worse than expected. The UK economy was an exception to this tendency and evidenced a balanced pattern of growth, which stood at slightly over 3% year-on-year. Inflation in the advanced economies has held at low levels (and generally below central bank targets) with the exception of Japan, where it stood at over 3% owing to the above-mentioned tax rise.

... and emerging economies alike

The emerging markets also weakened somewhat in the first half of 2014. In particular, in China, there was a manifest slowdown in activity in Q1, while in Q2 support from economic policy reversed the trend. There has also been a particularly sharp reduction in growth in Latin America (where investment is markedly weak) and in Russia and its neighbouring countries owing to the escalation of the crisis in Ukraine. Inflation in these economies has held relatively stable.

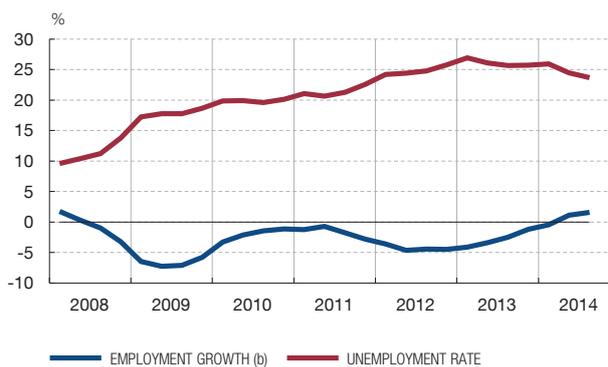
After the trough in the first half of the year, the outlook for the world economy is one of gradual recovery, although the risks of a less favourable performance remain in place

The disappointing growth figures in the first half of the year have prompted a significant downward revision of growth forecasts for the world economy in 2014 and 2015. However, once some of the temporary factors behind this slowdown have abated, the central scenario projects a gradual strengthening of the world economy over the coming quarters. In the advanced economies the improvement in activity will be underpinned by favourable monetary conditions, a lesser fiscal adjustment and the gradual recovery of labour markets.

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



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



SOURCES: INE, Eurostat and Banco de España.

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

And the pace of growth will foreseeably be mixed: brisker in the United States and the United Kingdom, and less dynamic in the euro area and Japan. A modest acceleration in activity is also expected in the emerging economies, assisted by the pick-up in demand from the advanced economies. But this scenario is subject to some downside risks to growth. Chief among these are those linked to a possible exacerbation of the situation in the various geopolitical hotspots, to a potential worsening of the situation on financial markets and to a possible unfavourable trend in inflation in some advanced economies.

The dynamism of GDP increased in Spain in Q2, as was reflected in the first year-on-year increase in employment since 2008...

In Spain, GDP posted growth of 0.6% quarter-on-quarter in Q2, 0.2 pp up on Q1, taking the year-on-year figure to 1.2%. This more favourable economic performance was reflected in increases in employment, which showed a positive year-on-year rate of increase for the first time since 2008 (see Chart 1.2.B). In this setting, and on EPA (Spanish Labour Force Survey) figures, the unemployment rate stood in June 2014 at 1.6 pp below the figure a year earlier, albeit remaining at a still very high level (24.5%). According to the INE flash estimate, GDP grew at a quarter-on-quarter rate of 0.5% in Q3. Over this same period the pace of year-on-year growth in employment rose, according to the EPA, with the unemployment rate falling to 23.7%.

... and the economic and financial situation of households and non-financial corporations tended to improve, although the degree of financial pressure remains very high...

The latest information on non-financial private sector balance sheets and incomes shows some improvement in the related economic and financial situation. Thus, non-financial corporations' debts continued to decline moderately, while the sector's profitability has tended to pick up, according to the latest Central Balance Sheet Data Office information. The improvement in firms' economic and financial situation is estimated to be relatively generalised, although those departing from a less favourable starting position are expected to have benefited to a greater extent.² In the case of households, the fall in unemployment combined with a reduction in debt and a slight rise in net wealth, associated with the increase in the value of net financial assets and in real estate wealth, which was in turn boosted by the modest rise in house prices in the first half of 2014 (see Box 1.1). In any event, the debt ratios of households and firms remain above the euro area average, and incomes have not regained pre-crisis levels, meaning these sectors remain subject to a high degree of financial pressure.

2 For more details see Box 1 in the article "Results of non-financial corporations to 2014 Q2", M. Méndez and Á. Menéndez, *Economic Bulletin*, Banco de España, September 2014.

3 The ratio is calculated according to the new European System of Regional and National Accounts (ESA 2010).

...while general government debt continued to rise, albeit at an increasingly moderate rate

In the case of general government, the latest data (for 2014 Q2) on the debt ratio place it at 96.3% of GDP³, 4.2 pp up on the end-2013 figure. Against this backdrop of high debt, the low level the cost of debt has reached offers significant relief in containing debt-associated expenditure. Furthermore, the latest developments in respect of the financing of this sector show a progressive slowdown in its liabilities, which grew at a rate of 6.1% in August (the latest figure available).

The economic and financial situation in Spain is improving, but the outlook is clouded by some substantial risks

In short, since the publication of the last FSR, financing conditions on domestic financial markets have improved. Further, the greater dynamism of Spanish GDP is translating into a pick-up in employment. These developments have been accompanied, moreover, by some strengthening in the economic and financial situation of the non-financial private sector. However, the economic recovery is still incipient and not free from risks, linked largely to the international context and to the need to complete the correction of certain domestic imbalances.

PRICE ADJUSTMENTS IN THE SPANISH REAL ESTATE MARKET

BOX 1.1

House prices in Spain peaked in 2007. This was followed by a process of adjustment, owing to the need to correct in part the previous sharp price increases, and to the significant contraction in demand associated with the decline in disposable household income, rising unemployment and tighter financing conditions against the backdrop of the economic and financial crisis.

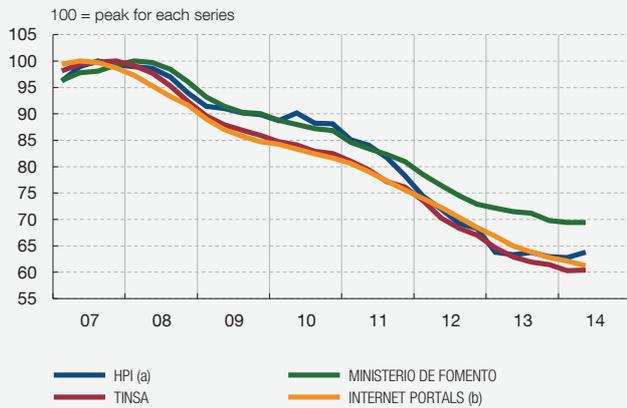
Thus, irrespective of the price measure considered, it can be seen that the correction had two main phases (2008-2009 and 2011-2013), consistent with the double-dip recession in the Spanish economy. In 2010 the fall in prices eased somewhat (influenced in part by tax reasons) and in 2014 to date prices appear to be stabilising, with even a timid rebound (see Panel B).

Since 2007, house prices have fallen by 30%-40%, according to how they are measured (see Panel A). The differences between the measures used are due to the difficulty of calculating a single representative value on what is a highly heterogeneous market, where prices vary significantly according to the location, type, characteristics, age, etc. of the property. Moreover, the different indicators are based on different data sources: deed of sale prices adjusted for quality of housing in the case of the INE house price index (IPV); appraisals in the case of the Ministry of Public Works and Tinsa; and asking prices in the case of the Internet portals. Accordingly, they may perform differently in terms of their sensitivity and responsiveness to market changes in whichever direction, which explains why neither the cumulative declines from peak values nor the year-on-year rates (see Panel B) coincide exactly. Nevertheless, the different indicators do all reflect a common general pattern.

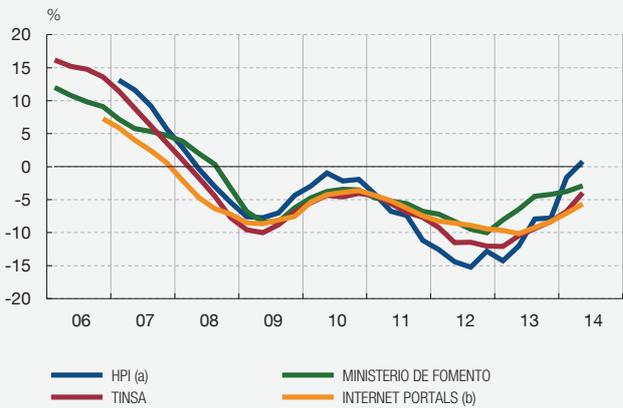
The correction recorded since 2007 represents a significant adjustment. Future price performance will continue to be influenced, in any event, by Spain's economic performance, by financing conditions which, despite monetary impulses in the euro area, are tighter than in the period previous to 2007 (see Panel C), and by the need to absorb the housing overhang. According to Ministry of Public Works estimates, at end-2013 the stock of unsold housing amounted to more than 560,000 units, having decreased by just 3% in that year and by 13% from its peak in 2009. In turn, the demand for housing (number of housing market transactions; see Panel D) has recovered slightly (driven in part by foreign buyers), although it naturally remains considerably below the highs recorded in the boom years.

Against this backdrop, in recent months differences have been observed in price performance by region, with prices in certain regions (such as the Balearic and Canary Islands, and some provincial capitals) moving on a more expansionary course.

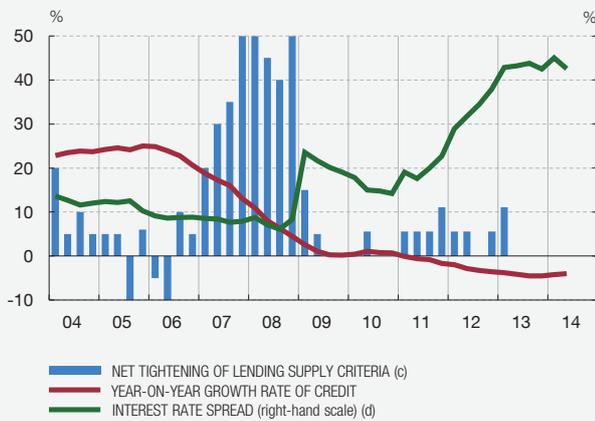
A. HOUSE PRICES
Levels



B. HOUSE PRICES
Year-on-year rates



C. FINANCING CONDITIONS FOR HOUSE PURCHASE BY HOUSEHOLDS



D. NUMBER OF QUARTERLY NEW AND SECOND-HAND HOUSE TRANSACTIONS (e)



SOURCES: Expocasa, Fotocasa, Idealista, INE, Ministerio de Fomento, Tinsa and Banco de España.

- a INE house price index.
- b Average of the fluctuations in the average prices of Expocasa, Fotocasa and Idealista.
- c Bank Lending Survey. Percentage of banks reporting a tightening of their new-loan-approval standards less percentage of those reporting an easing in lending standards.
- d Difference between the average interest rate on new loans to households for house purchase and 12-month EURIBOR.
- e Public-deeded housing transactions, from the Ministry of Public Works statistic on real estate transactions.

2 DEPOSIT INSTITUTIONS

2.1 Banking risks

2.1.1 CONSOLIDATED BALANCE SHEET OF DEPOSIT INSTITUTIONS

The consolidated total assets of deposit institutions contracted by 5.8% between June 2013 and June 2014

The consolidated total assets of deposit institutions, which include both their business in Spain and that of their subsidiaries and branches abroad, amounted to €3,534 billion in June 2014. They thus contracted by 5.8% between June 2013 and June 2014 (see Table 2.1), continuing the downward trend in the balance sheet reported in previous FSRs.

The decline in assets was caused by the performance of business in Spain, which explains why business abroad, measured in terms of the aggregate balance sheet of deposit institutions at consolidated level, increased its relative weight from 29.2% in June 2013 to 31.6% in June 2014.

In assessing the foreseeable impact on financial stability of the increasing relative weight of business abroad over the last few years as a result of the sharper falls in, or lower growth of, business in Spain, it must be taken into account that the model adopted by Spanish deposit institutions in their expansion abroad is based on financially autonomous subsidiaries engaging essentially in retail banking in local currency.

Although financing to the private sector in year-on-year terms as at June 2014 decreased, its relative weight in the balance sheet rose...

Financing to the private sector, which includes credit¹ and fixed income, declined by 4.6% in the past year (see memorandum item of Table 2.1). This year-on-year decrease came as a result of falls both in its main component, credit to the private sector, which decreased by 3.7%, and in private-sector fixed income securities (15.8%), and centred on business in Spain, the behaviour of which is analysed below in greater detail. All told, the smaller year-on-year fall in financing to the private sector (4.6%) with respect to that in total assets between June 2013 and June 2014 (5.8%) explains why the weight of financing to the private sector increased in the period in relative terms, from 60.6% of the total balance sheet in June 2013 to 61.3% in June 2014 (see Chart 2.1.A).

...as did financing to general government, the year-on-year rate of change of which increased

Financing to general government (credit and fixed income) posted a year-on-year increase of 2.2% at June 2014, mainly due to the rise in fixed income, since credit (smaller amount in relative terms) remained practically unchanged in June 2014 relative to June 2013. The increase in financing to general government, whose relative weight rate in consolidated balance sheets has been rising (see Chart 2.1.A) was due to its growth in business abroad, since in business in Spain it remained practically unchanged between June 2013 and June 2014.

Total NPLs at consolidated balance sheet level and the associated NPL ratio increased in year-on-year...

Total NPLs at consolidated balance sheet level and the NPL ratio at consolidated level showed a certain change in trend from June 2013 to June this year. Thus, between June 2013 and June 2014 NPLs grew by 4.7% and the NPL ratio rose by 70 bp to 7.3%.² However, comparison of the values for June 2014 (the most recent figures at consolidated

¹ From January 2014 *establecimientos financieros de crédito* (previously "specialised credit institutions", now "credit financial intermediaries") are no longer classified as credit institutions, so the loans and deposits arising from them ceased to be sectorised under the related CI headings. To enable the various balance sheet items involved to be compared over time, the data taken from the individual financial statements are appropriately adjusted to neutralise the change. However, at consolidated level, no such adjustment has been made, since a number of credit financial intermediaries are subsidiaries of deposit institutions. These effects have a scant impact on the consolidated balance sheet, but they have to be taken into account in year-on-year comparisons.

² In addition to credit to and NPLs of the resident private sector, this figure includes those relating to general government and credit institutions. This, in addition to the scope of consolidation, means that the ratio given here differs from that analysed in greater detail in Section 2.1.2 of this Report, which refers to credit to the resident private sector in Spain.

CONSOLIDATED BALANCE SHEET.
DEPOSIT INSTITUTIONS

TABLE 2.1

Assets	Jun-14	Change	Relative	Relative
	(€m)	Jun-14/ Jun-13 (%)	Weight Jun-13 (%)	Weight Jun-14 (%)
Cash and balances with central banks	123,755	-4.5	3.5	3.5
Loans and advances to credit institutions	180,212	-24.8	6.4	5.1
General government	108,632	0.8	2.9	3.1
Other private sectors	2,024,355	-3.7	56.1	57.3
Debt securities	612,815	-4.8	17.2	17.3
Other equity instruments	44,458	24.0	1.0	1.3
Investments	46,874	-12.7	1.4	1.3
Derivatives	168,437	-21.1	5.7	4.8
Tangible assets	52,807	10.1	1.3	1.5
Other (b)	171,279	-2.5	4.7	4.8
TOTAL ASSETS	3,533,624	-5.8	100	100
Memorandum items				
Financing to private sector	2,167,780	-4.6	60.6	61.3
Financing to general government	518,643	2.2	13.5	14.7
Total NPLs	213,548	4.7	5.4	6.0
Total NPL ratio	7.3	70 (d)		
Loan loss and country risk provisions (a)	-123,602	-2.6	-3.4	-3.5
Liabilities and equity	Jun-14	Change	Relative	Relative
	(€m)	Jun-14/ Jun-13 (%)	Weight Jun-13 (%)	Weight Jun-14 (%)
Balances from central banks	186,979	-31.4	7.3	5.3
Deposits from credit institutions	382,952	-13.7	11.8	10.8
General government	105,881	-4.7	3.0	3.0
Other private sectors	1,765,820	0.5	46.9	50.0
Marketable debt securities	399,299	-10.7	11.9	11.3
Derivatives	162,845	-16.5	5.2	4.6
Subordinated debt	46,210	9.4	1.1	1.3
Provisions for pensions and tax	34,929	-7.1	1.0	1.0
Other (b)	199,279	-6.0	5.7	5.6
TOTAL LIABILITIES	3,284,193	-6.7	93.8	92.9
Memorandum items				
Eurosystem net lending (c)	154,798	-35.8	6.4	4.4
Minority interests	30,346	17.1	0.7	0.9
Valuation adjustments relating to total equity	-10,633	.	-0.4	-0.3
Own funds	229,719	3.9	5.9	6.5
TOTAL EQUITY	249,431	8.1	6.2	7.1
TOTAL LIABILITIES AND EQUITY	3,533,624	-5.8	100	100

SOURCE: Banco de España.

a In addition to country risk provisions, it includes specific and general provisions for credit risk.

b The remaining assets and liabilities entries not explicitly considered, including valuation adjustments, are included in "Other".

c Difference between funds received in liquidity providing operations and funds delivered in absorbing operations. September 2014 data (latest available) and September 2013 data to maintain the year-on-year comparison.

d Difference calculated in bp.

...terms, but have fallen from December 2013

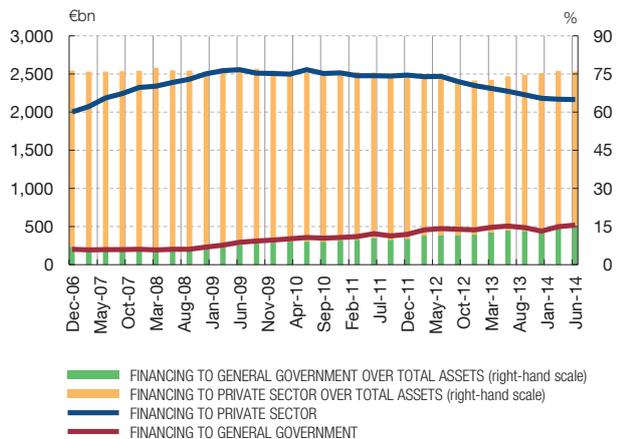
level) with those for December 2013 (the last FSR) reveals a decrease of 4.2% in total NPLs and of 0.5 pp in the total NPL ratio (from 7.8% in December 2013 to 7.3% at present).

The behaviour of total NPLs and of the NPL ratio is mainly attributable to business in Spain, where, as analysed in greater depth in Section 2.1.2 on credit to the resident private

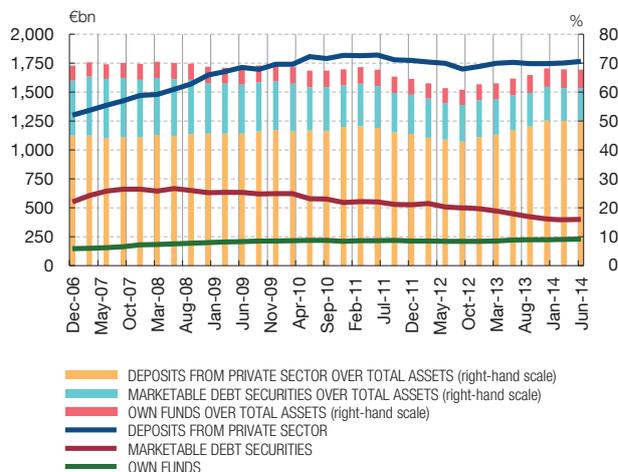
CONSOLIDATED BALANCE SHEET
Deposit institutions

CHART 2.1

A. ASSETS. AMOUNTS (lines, left-hand scale) AND PERCENTAGE OF TOTAL ASSETS (columns, right-hand scale)



B. LIABILITIES AND EQUITY. AMOUNTS (lines, left-hand scale) AND PERCENTAGE OF TOTAL ASSETS (columns, right-hand scale)



SOURCE: Banco de España.

sector, the NPL growth rate has slowed in recent months. Meanwhile, in business abroad, NPLs were already posting year-on-year falls at June 2014 (2.5%), and slight declines were apparent in the NPL ratio (from 3% at June 2013 to 2.9% at June 2014), which was running at appreciably lower levels than the total NPL ratio of business in Spain.

Loan loss and country risk provisions decreased by 2.6% between June 2013 and June 2014 (see memorandum item of Table 2.1). The reasons for this behaviour, which was uneven across banks, were various, at a time when some of them are managing to reduce their NPLs in absolute terms and others are cutting back their rate of increase. Taking into account these developments, there are three main reasons for the year-on-year decrease in loan loss provisions. First, charge-offs; second, additions to retail mortgage NPLs as a result of review of the related forbore exposures, where, because of their nature (normally collateralised), the legally stipulated provisions are lower than in other lending; and, finally, reclassifications to NPLs from the property development portfolio to which the general provisions recorded under Royal Decree-Laws 2/2012 and 18/2012 were reassigned.

Derivatives on the assets side showed a decrease of 21.1% year-on-year at June 2014, similar to that on the liabilities side (16.5% in June 2014 with respect to the same month a year earlier), so the net position in derivatives (assets less liabilities) remained at very low levels in terms of the balance sheet total. In any event, as noted in previous FSRs, the downward trend of derivatives is largely explained by the more extensive use of position netting agreements.

Balances from central banks decreased, reflecting the decline in liquidity taken by banks from the Eurosystem...

A notable development in consolidated total liabilities (see Table 2.1) was the decrease in balances from central banks, down 31.4% year-on-year at June 2014. This item has been decreasing in recent periods as a result of the correction of the sharp upturn seen in 2012 due to banks' operations with the Eurosystem, which provided long-term liquidity to allay euro area financial market tensions and malfunctions, particularly in the money markets. These operations with the Eurosystem reached their peak in August 2012, and since then have declined considerably in amount. The latest available figure, for September 2014,

puts the net recourse to the Eurosystem by Spanish banks (difference between funds received and deposited) at 4.4% of their consolidated balance sheet total, as compared with 6.4% at September 2013 (see liabilities memorandum item of Table 2.1).

...as did deposits from credit institutions...

Deposits from credit institutions fell by 13.7% between June 2013 and June 2014, and, as a result, their relative weight was down by 1 pp to 10.8%. Their year-on-year fall was less than that of assets (24.8%), where credit to deposit institutions lost relative weight in total assets, falling by more than 1 pp from 6.4% to 5.1%.

...while deposits from the private sector grew slightly, gaining relative weight within bank balance sheets.

Private sector deposits grew by 0.5% year-on-year at June 2014 (see Table 2.1), with similar growth rates in business in Spain and in business abroad. Although the increase in deposits was moderate, notably they were, along with subordinated debt, the only liability item of deposit institutions to show a positive year-on-year rate of change at June 2014. This change gave rise to an increase in their relative weight in the total balance sheet from 46.9% at June 2013 to 50% at June 2014 (see Chart 2.1.B). This boosted the relative weight of private sector deposits compared with other sources of funding for deposit institutions.

Marketable debt securities decreased in volume between June 2013 and June 2014

In this respect, although financial market conditions have become more favourable in recent months, prompting securities issuance by some Spanish deposit institutions, marketable debt securities as a whole continued their downward path, falling by 10.7% at June 2014, so their relative weight in the balance sheet dropped from 11.9% to 11.3% (see Table 2.1). Subordinated debt showed an increase of 9.4% at June 2014 relative to the same month a year earlier, so its relative weight in the balance sheet rose from 1.1% at June 2013 to 1.3% at June this year. This development in subordinated debt came as a result of the issues launched by some larger institutions in the period under analysis.

The equity of banks increased, as did the weight of own funds in the balance sheet

The total equity of deposit institutions increased by 8.1% year-on-year at June 2014. This increase gave rise to a strengthening of equity in the balance sheet structure of banks, since its relative weight rose by nearly 1 pp from 6.2% at June 2013 to 7.1% at June 2014. The own funds of banks grew by 3.9% to stand at 6.5% of consolidated total assets in June 2014 (see Table 2.1).

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

Credit to the resident private sector in business in Spain, as per individual financial statement data, showed at June 2014 a year-on-year rate of change of -8%,³ similar to that in August 2014 (-8.2%), the latest figure available (see Chart 2.2.A).

In the first half of the year, credit to the resident private sector showed signs of a moderation in its rate of decline, both for households and for non-financial corporations

The data to June 2014, which are the latest available figures allowing a year-on-year comparison of credit by sector, show a moderation in the rate of decline for both households (fall of 4.5% at June 2014 against a decrease of 5.5% at December 2013) and non-financial corporations (fall of 9.6% at June 2014 against a drop of 11.1% at December 2013, after adjustment of this latter rate for the transfer of assets to Sareb⁴).

In credit to households, the year-on-year rate of contraction moderated in both that for house purchase (fall of 4.2% at June 2014, against a fall of 4.6% at December 2013) and

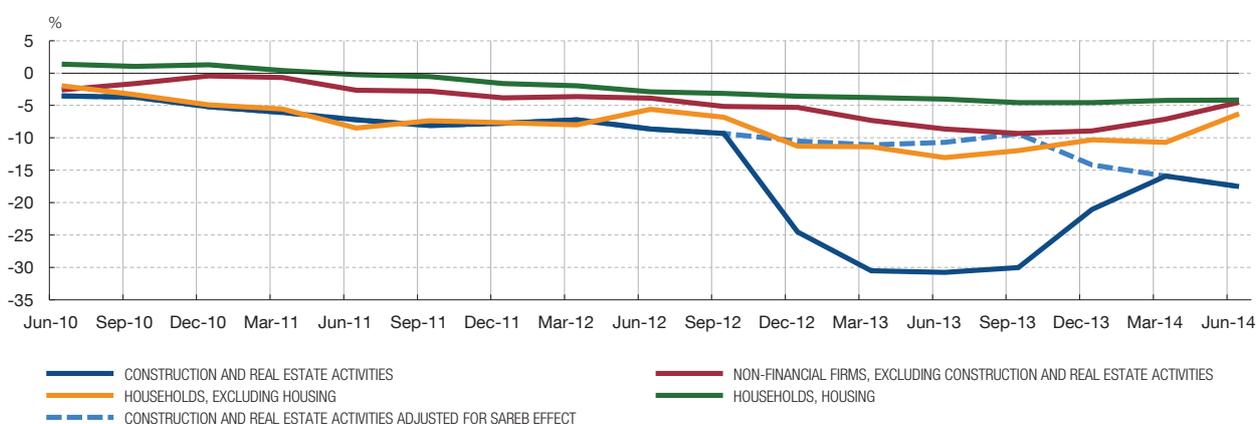
³ From January 2014 *establecimientos financieros de crédito* (previously "specialised credit institutions", now "credit financial intermediaries") are no longer classified as credit institutions. This reclassification means that credit granted to these entities is now considered to be credit to the resident private sector. To enable these time series to be compared over time, the pertinent adjustments have been made to neutralise the change.

⁴ The transfers to Sareb in February 2013 mean that the year-on-year rate of change at December 2013 would be lower if the related adjustment were not made. This is especially so for credit to real estate and construction companies, although it also affects total credit and that to non-financial corporations as a whole.

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



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



SOURCE: Banco de España.

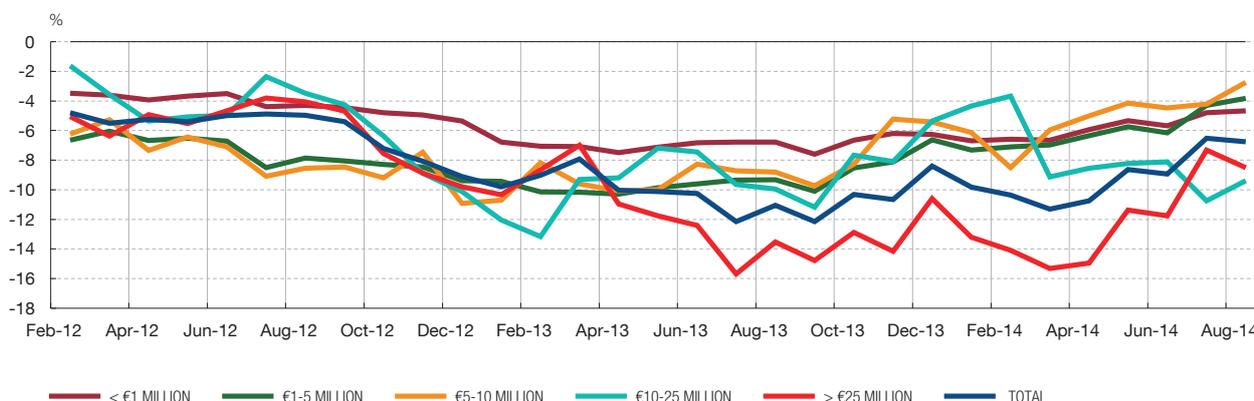
that for other purposes (decrease of 6.3% year-on-year at June 2014 against a decline of 10.3% at December 2013, see Chart 2.2.B).

For non-financial corporations, the moderation in the rate of decline in credit was concentrated in firms other than those in real estate and construction. Thus, for these other business activities, the fall in credit was 4.5% at June 2014 against 8.9% at December 2013 (see Chart 2.2.B).

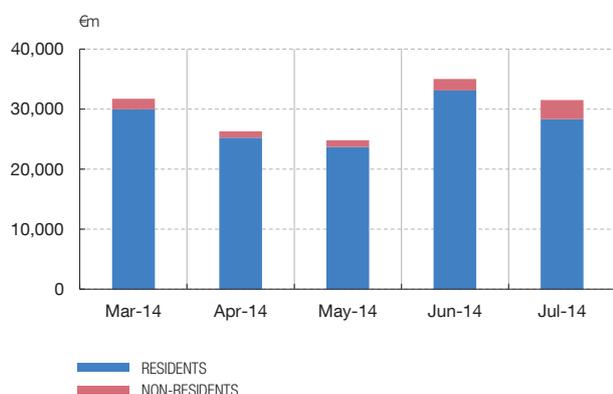
In non-financial corporations other than those in real estate and construction, the pace of contraction of credit slowed, and this moderation was widespread across the spectrum of firm sizes as approximated by volume of bank debt per the CCR

In non-financial corporations other than those in real estate and construction, the moderation in the fall in credit was seen to be rather widespread when analysed by company size. Until recently, information on firm size was not available directly from the regulatory returns sent by banks to the Banco de España, so different approximations were used. However, since March 2014 loan information distinguishing companies by size has been available from the data directly reported by banks, although year-on-year comparisons are not yet available (see Box 2.1). In any event, Chart 2.3.A approximates the size of borrowers, with the usual limitations, on the basis of the volume of the borrower's bank debt reported to the Central Credit Register (CCR), as has been done in the FSR so far. It can be seen that in recent months the rate of decline of credit has moderated across all size classes, except for borrowers with a volume of bank debt

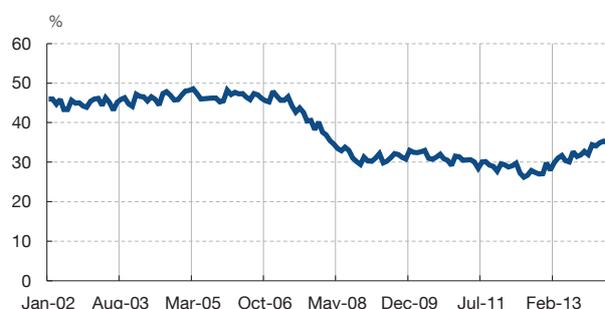
A. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO NON-FINANCIAL FIRMS, EXCLUDING CONSTRUCTION AND REAL ESTATE ACTIVITIES, BY SIZE OF CORPORATION (a)



B. NEW CREDIT GRANTED TO THE PRIVATE SECTOR



C. ACCEPTANCE RATES FOR CREDIT APPLICATIONS OF NON-FINANCIAL FIRMS (b)



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

- a Firm size is proxied by the volume of bank debt reported to the Banco de España Central Credit Register.
- b Non-financial firms which apply for a loan to an institution with which they are not working or they have not maintained a credit relationship in the last three months. The acceptance rate is defined as the ratio between the transactions accepted by deposit institutions and the total applications received in a particular month.

between €10 million and €25 million (see Chart 2.3.A). The behaviour of credit to smaller firms may be partly due, as analysed in Chapter 3 of the previous FSR, to the impact of regulatory changes in credit to SMEs, consisting of a broader definition of SMEs in line with EU practice, and in regulatory capital requirements (which Capital Requirements Directive 2013/36/EU eases for SMEs).

For the first time information was available on new credit granted in the system, which amounted to approximately €150 billion between March and July 2014

From March 2014 banks have to send to the Banco de España, through a regulatory return, the new credit granted by them, so this information is now available for the first time without having to resort to approximations. Owing to the recentness of this information, for the time being long time series allowing year-on-year comparison of changes in new credit are not available. To this limitation must be added the due caution associated with the first disclosures of a new regulatory return. In any event, Chart 2.3.B shows the monthly changes in new credit to the total private sector (resident and non-resident), which amounts to approximately €150 billion between March and July 2014 (Box 2.1 gives more details of the composition, by type of non-financial corporation, of new credit).

Since March 2014, deposit-taking institutions have been obliged to submit a new regulatory return which extends and enhances the previously-existing one on the classification of lending to the private sector by type of borrower based on economic activity. The two main changes to this return are as follows:

- For the first time, it is possible to ascertain, from an official return, rather than by means of approximations, the volume of credit granted to small and medium-sized enterprises (SMEs).
- Also for the first time, it is possible to find out the volume of new lending¹ in the system and how it divides up between different borrowers (institutional sectors and industries).

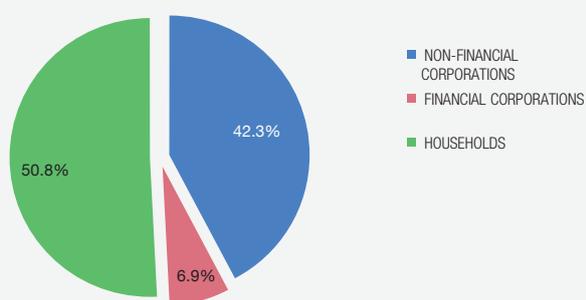
The new return offers additional information on, inter alia, forbore loans (see Box 2.2), lending to non-residents and the type of borrower. Using June 2014 data, this box provides, for the first time, information in relation to these two main changes.

Lending to SMEs

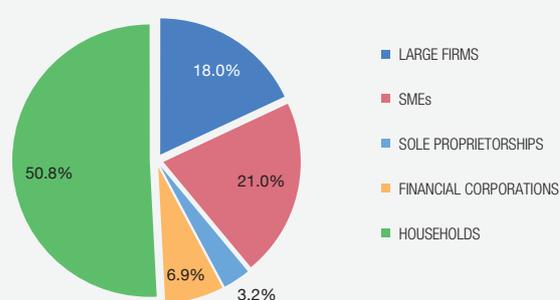
In June 2014, non-financial corporations received 42.3% of the financing extended to the resident private sector. Households, for their part, received 50.8% (see Chart A).

¹ This consists of new loans granted by banks, other than the rollover or refinancing transactions referred to by section 1 (g) of Annex IX of Circular 4/2004, or subrogations of debtors arising from previous periods.

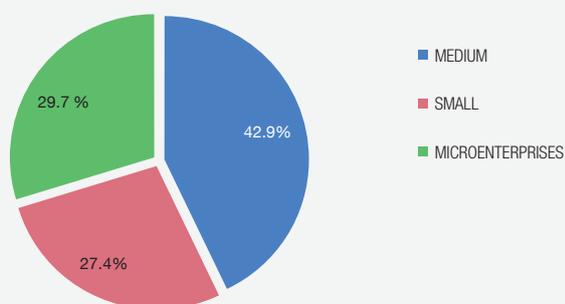
A. FINANCING TO THE RESIDENT PRIVATE SECTOR. June 2014



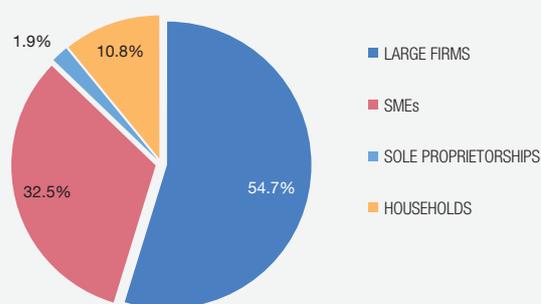
B. FINANCING TO THE RESIDENT PRIVATE SECTOR. June 2014



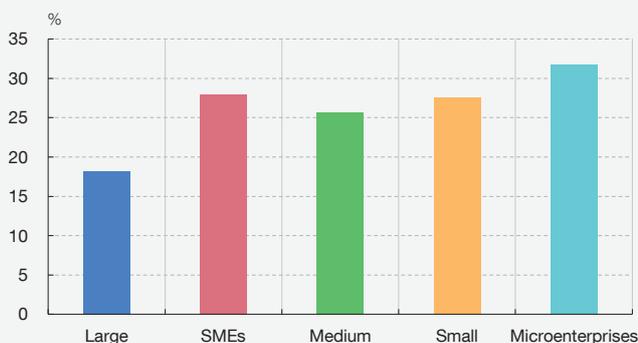
C. FINANCING TO SMEs. June 2014



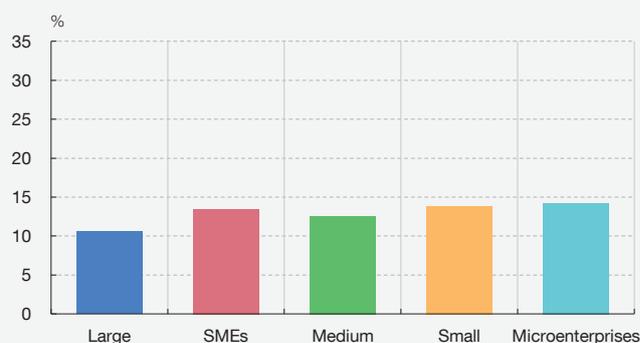
D. LOANS GRANTED TO THE RESIDENT PRIVATE SECTOR IN THE PERIOD MARCH-JUNE 2014



E. NPL RATIO June 2014



F. NPL RATIO EXCLUDING CONSTRUCTION AND REAL ESTATE ACTIVITIES June 2014



SOURCE: Banco de España.

Breaking down the financing received by non-financial corporations, the volume of credit received by SMEs from Spanish deposit-taking institutions amounted to around €290 billion (21% of the total lending to the resident private sector, see Chart B), while the volume extended to large firms was more than €236 billion (18%, see Chart B). Within SMEs (see Chart C), 42.9% of the credit granted corresponds to medium-sized enterprises, 27.4% to small enterprises and the remaining 29.7% to microenterprises, as defined by the European Commission.²

In terms of credit quality, the overall NPL ratio of non-financial corporations stood at 22.5% in June 2014, with differences according to the size of the enterprise considered. Thus, the ratio for large enterprises was 18.2% and for SMEs 28%. Within the latter group, while medium-sized enterprises had a ratio of 25.7%, that of small enterprises was 27.5%. Finally, the smallest SMEs, i.e. microenterprises, had the highest NPL ratio, 31.7% (see Chart E). These data indicate that size is positively related to credit quality.

If those enterprises that engage in real estate activities and construction are excluded from the set of non-financial corporations, the conclusions regarding the relative order of their NPL ratio by firm size do not change. However, within each size bracket, the NPL ratio of non-financial corporations excluding real estate and construction firms is significantly lower (see Chart F). Thus, for example, in the

case of large enterprises it falls from 18.2% to 10.6%, while for SMEs as a whole it falls from 28% to 13.5%.

New credit

On data for the period March-June 2014, out of the total amount drawn down of the new credit granted in the system to finance the resident private sector, 89% corresponds to the financing of non-financial corporations, and the other 11% to households (see Chart D).

Breaking down the above figure for new financing received by non-financial corporations, 54.7% of the total volume of new credit transactions corresponded to large enterprises, 32.5% to SMEs and 1.9% to sole proprietorships. Within SMEs, of the total new credit granted, 8.8% corresponded to medium-sized enterprises, 10.2% to small enterprises and 13.4% to microenterprises.

² An enterprise is an SME if it complies with the definition in Commission Recommendation 2003/361/EC of 6 May 2003 (OJ L 124 of 20 May 2003). An SME is considered to be an enterprise employing fewer than 250 persons and which has an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million. Within the SME category, a small enterprise is defined as one that employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed €10 million and a microenterprise as an enterprise employing fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed €2 million.

The rate of acceptance of loan applications made by non-financial corporations in recent months continues to follow the upward trend of previous quarters

In short, the contraction of credit is steadying, and the rate of decline is moderating for firms other than those in real estate and construction

NPLs to the resident private sector increased at a more moderate rate

CCR data can be used to calculate the acceptance rates of loan applications made by non-financial corporations to deposit institutions with which they are not working or with which they have not had a credit relationship in the preceding few months.⁵ The acceptance rates in these last few months continue to show, albeit with certain volatility, the upward trend of previous quarters, running at levels around 35% (see Chart 2.3.C).

In short, the latest available data show that the aggregate amount of credit continued to contract, although its rate of decline has steadied. This aggregate behaviour continues to be influenced by the need to correct the high indebtedness of the private sector, although differing rates of decline are discernible, being slowest in bank financing to firms other than those in real estate and construction.

Forborne (restructured and refinanced) loans continue to form a significant part of the credit portfolio of deposit institutions, although the data relating to June 2014 indicate that, with respect to December 2013, their amount remained practically unchanged (-0.2%), as noted in Box 2.2, which analyses transactions of this type for the various sectors of activity.

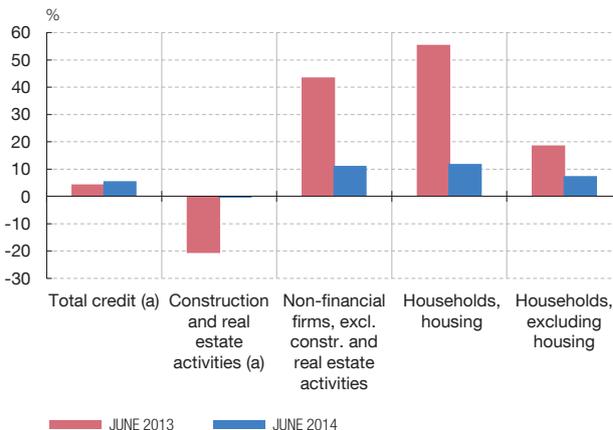
NPLs to the resident private sector in business in Spain (data per banks' individual financial statements) showed growth of 5.5% at June 2014 with respect to June of the previous year. The most recent figure, that for August 2014, reflected a smaller year-on-year change,

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

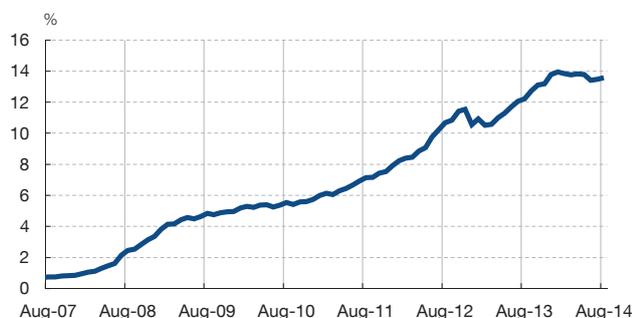
A. YEAR-ON-YEAR RATE OF CHANGE IN NPLs (a)



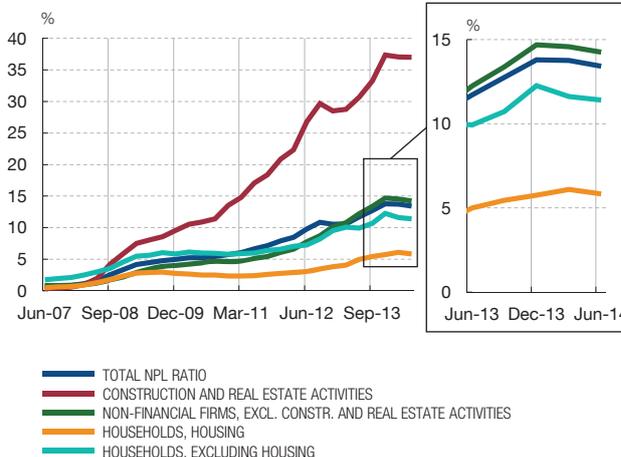
B. YEAR-ON-YEAR RATE OF CHANGE IN NPLs BY SECTOR OF ACTIVITY



C. NPL RATIO



D. NPL RATIO, BY SECTOR OF ACTIVITY



SOURCE: Banco de España.

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

of 2.1%, continuing the trend towards progressive moderation of the year-on-year rate of increase of NPLs (see Chart 2.4.A), with continual month-on-month falls from January this year to the latest date for which data are available.

Significant differences persist across sectors/industries

The data relating to June 2014 (the latest available figures allowing year-on-year comparison) show that resident private sector NPLs differ across institutional sectors and industries (see Chart 2.4.B).

For firms other than those engaging in construction and real estate development, the rate of increase of NPLs moderated significantly...

For non-financial corporations, the rate of change of NPLs of 3.9% at June 2014 was the result of a slight decrease in those arising from construction and real estate firms (0.5%) and a year-on-year increase of 11.2% at June 2014 for other non-financial corporations. The growth rate of NPLs of the latter firms moderated significantly (it was 43.6% at June 2013). This improved performance was widespread across the various industries, and slight year-on-year falls in the volume of NPLs at June 2014 were posted by some corporate sectors, such as agriculture and fishing (1.7%) and accommodation and food service activities (0.2%).

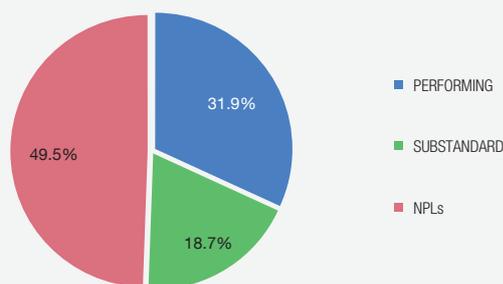
Based on individual financial statements, the total amount of forborne (refinanced and restructured) loans, as defined in section 1(g) of Annex IX to Banco de España Circular 4/2004, stood at €210,720 million in June 2014 (down 0.2% from December 2013). Almost half of this amount (49.5%) is classified as NPLs, 31.9% as performing and the remaining 18.7% as substandard (see Chart A).

forborne transactions), the sectoral breakdown of forborne loans¹ (see Chart B) shows that almost two-thirds of them are to companies (65.2%) and slightly more than one-third are to households (34.8%).

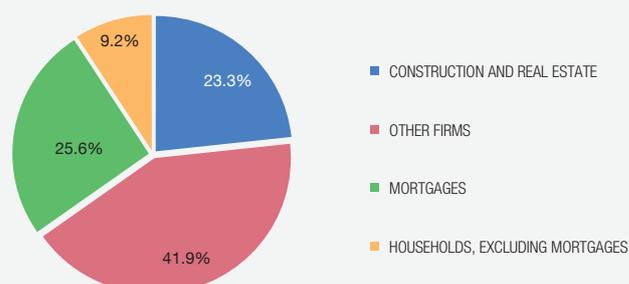
Focusing on the resident private sector (i.e. excluding forborne loans to general government, which account for 1.7% of total

¹ Data taken from the new regulatory return, which provides greater detail by borrower (see Box 2.1). Slight differences may arise with respect to the data used in previous Financial Stability Reports, but they would be minor and not affect the conclusions drawn.

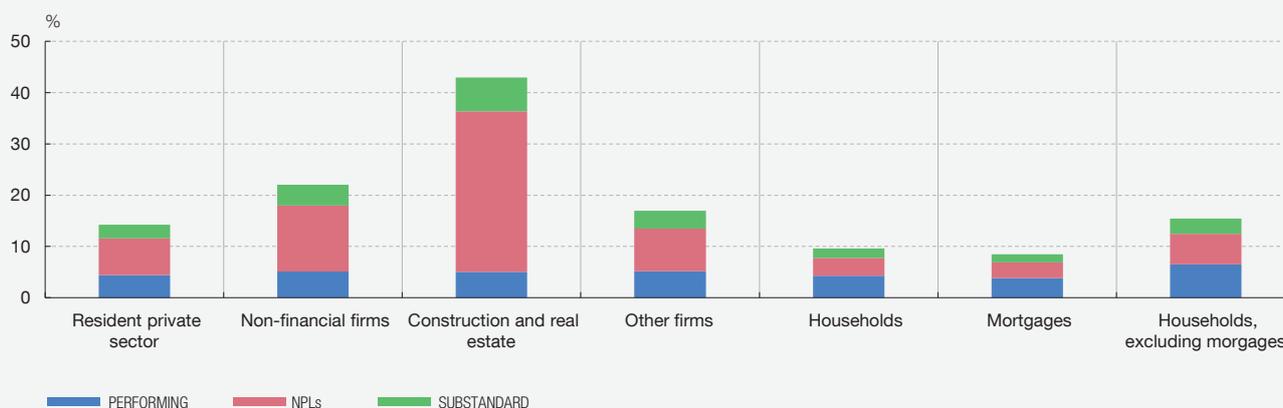
A. CREDIT QUALITY OF FORBORNE LOANS. June 2014



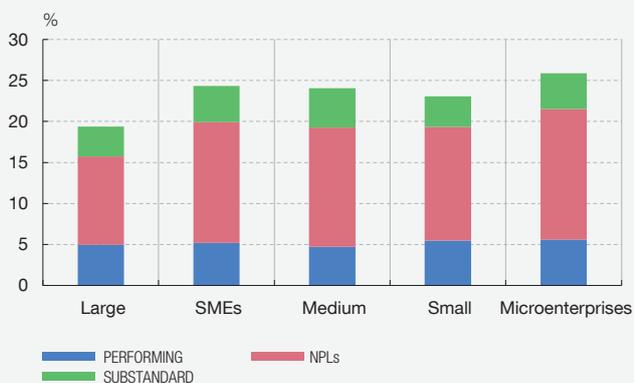
B. SECTORAL BREAKDOWN OF FORBORNE LOANS TO THE PRIVATE SECTOR. June 2014



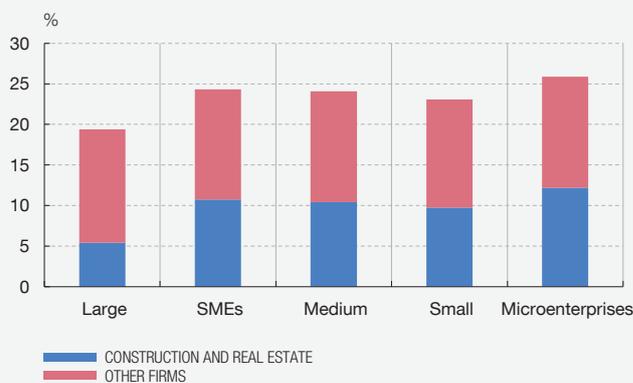
C. WEIGHT OF FORBORNE LOANS IN THEIR RESPECTIVE PORTFOLIO AND BREAKDOWN BY CREDIT QUALITY STATUS. June 2014



D. WEIGHT OF FORBORNE LOANS IN THEIR RESPECTIVE PORTFOLIO, BY SIZE OF FIRM, AND BREAKDOWN BY CREDIT RISK. June 2014



E. WEIGHT OF FORBORNE LOANS IN THEIR RESPECTIVE PORTFOLIO, BY SIZE OF FIRM, AND BREAKDOWN BY SECTOR OF ACTIVITY. June 2014



SOURCE: Banco de España

Chart C shows the weight of forborne loans in total lending, and their breakdown into performing, substandard or NPLs.

The weight of forborne loans in total lending to the resident private sector is close to 15%. However, the breakdown into corporations and households discloses significant differences. For non-financial corporations forborne transactions account for 22% of total lending, whereas for households the relative share is just 9.6%. Additionally, the classification of forborne lending based on credit quality also differs substantially between sectors: 58% of forborne loans to non-financial corporations are classified as NPLs as compared with 36% of those to households.

Within non-financial corporations, forborne loans to construction and real estate firms account for 43% of total lending to this industry (72% of which are classified as NPLs). For other corporations, the weight of forborne loans in total lending is 17%.

In the household sector, significant differences are apparent between housing and other loans. Forborne loans for house purchase account for 8% of the total, while the share for other loans is 15%.

By firm size (see Chart D), forborne loans to SMEs (as defined in Commission Recommendation 2003/361/EC of 6 May 2003) account for 24% (60% of which are NPLs). For large corporations, 19% of their total loans have been forborne (55% of which are NPLs). The share of forborne loans is quite similar among the different types of SME, with only microenterprises accounting for a slightly higher percentage (26%).

Finally, by sector of activity, 28% of forborne loans are to firms engaged in construction and real estate activities in the case of large corporations, whereas the share is 44% for SMEs, reaching 47% for microenterprises (see Chart E).

...as it did, albeit to differing extents depending on the loan purpose, for households

Meanwhile, household NPLs grew by 10.7% year-on-year at June 2014, also slowing with respect to previous periods (43.4% at June 2013). The breakdown for households into house purchase loans and other loans shows the same trend, although to a different extent. While the former increased by 11.9% (compared with growth of 55.5% at June 2013), the latter were up by 7.5% at June 2014, against 18.7% for the same month a year earlier (see Chart 2.4.B).

The NPL ratio of the resident private sector decreased slightly from December 2013 until the date of the latest available data,...

In June 2014 the NPL ratio of the resident private sector in Spain was 13.4%,⁶ up 171 bp on June 2013. This year-on-year change resulted from growth in the amount of NPLs and from a decrease in the volume of outstanding credit (denominator of the ratio). However, the downward trend of NPLs from December 2013 explains why the ratio went from 13.8% at that date to 13.6% in August 2014, the latest monthly figure available (see Chart 2.4.C).

...a downward trend apparent in the various sectors of activity

This slight decrease in the NPL ratio was observed widely across the various sectors of activity (see Chart 2.4.D). Thus, in household credit, the NPL ratio was 6.7% in June 2014, slightly lower than in March that same year (6.9%). In household credit for house purchase, the NPL ratio went from 6.1% in March 2014 to 5.8% in June this year, while in household credit for purposes other than house purchase the slight moderation of the NPL ratio took place from December 2013, slowing from 12.3% to 11.4% in June 2014.

The NPL ratio of non-financial corporations as a whole, at 22.5% in June 2014, was also slightly down on end-2013, when it reached 23.3%. There were notable differences among non-financial corporations in the NPL ratio for credit to the real estate and construction sector (37% in June 2014) and to other non-financial corporations (14.3% in June 2014). However, the NPL ratio has behaved similarly in the two sectors in 2014 to date, with the ratios in June 2014 being lower than in December 2013 (see Chart 2.4.D).

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

In conclusion, the rate of increase of NPLs has shown a relatively widespread moderation, with month-on-month falls from January 2014 which are reflected in a very slight decrease in the NPL ratio in the year so far

In short, the total volume of NPLs of the resident private sector has shown a relatively widespread moderation in its year-on-year rate of increase, posting month-on-month falls from January 2014 to the date of the latest available figures in August this year. The NPL ratio stopped growing and decreased slightly from end-2013 to August 2014, reflecting the cumulative fall in NPLs in that period, which, however, was largely dampened by the downward trend of aggregate credit (denominator of the ratio). As the recovery of the Spanish economy moves onto a firmer footing, the improvement in NPLs throughout 2014 may also become more strongly entrenched, along with the downward trend in the NPL ratio, which is, however, a variable that lags the economic cycle.

Turning to foreclosed assets (those which become part of bank balance sheets as a result of debt enforcement proceedings or of a debt settlement agreement between borrower and lender), their volume at consolidated level grew by 8.4% with respect to June 2013, while remaining practically unchanged between December 2013 and June 2014 (up by 0.6%).

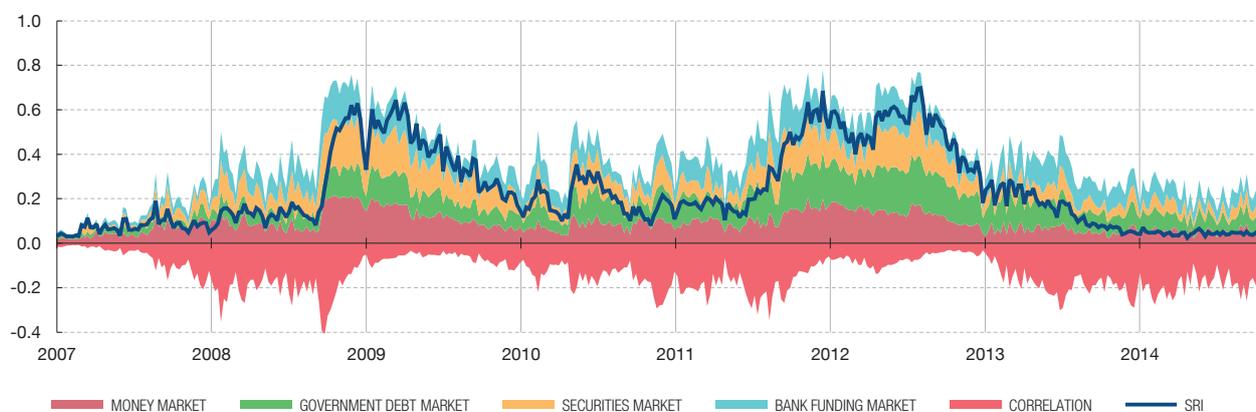
2.1.3 FUNDING OF THE BANKING SECTOR

As noted in Chapter 1 of this FSR, since the last FSR a climate of stability has prevailed in the financial markets, and this was reflected in the ongoing low levels of the systemic risk indicator in Spain following the highs reached around summer 2012 (see Chart 2.5). In the past year, systemic risk in Spain has steadied at low levels near to those recorded before the financial crisis. This steadiness is apparent in all the markets covered by the systemic risk indicator: government debt, money, securities and bank funding markets. For all of them, despite isolated upturns, steady low levels have predominated in the past year. The favourable performance of these markets in the past year is generally attributable to their low volatility, together with growing confidence and an improvement in investors' perception of Spain's economic and financial situation.

Securities issuance by Spanish deposit institutions has held at low levels in recent months, although various institutions have issued subordinated debt, the volume in the second and third quarters being lower than in the first quarter of 2014 (see Chart 2.6.A). As noted at the beginning of this chapter, the adjustment of the mix of Spanish institutions' liabilities to reduce their dependence on wholesale funding and thus increase the relative weight of retail funds in the funding structure goes some way towards explaining the low issuance activity of Spanish institutions, despite the improved conditions in financial markets. To these reasons must be added the ongoing downward trend in lending.

SYSTEMIC RISK INDICATOR (SRI) (a)

CHART 2.5



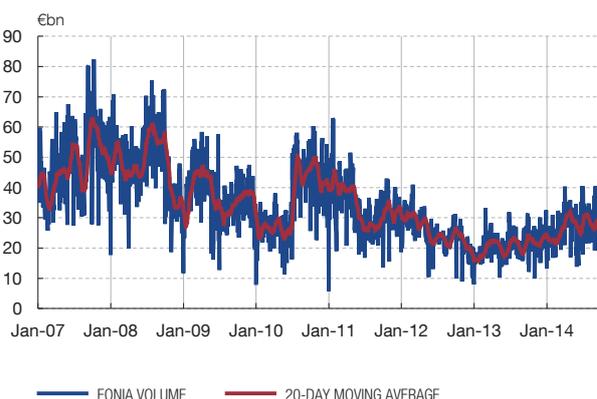
SOURCES: Datastream, ECB and Banco de España.

a For a detailed explanation of this indicator, see Box 1.1 in the May 2013 FSR.

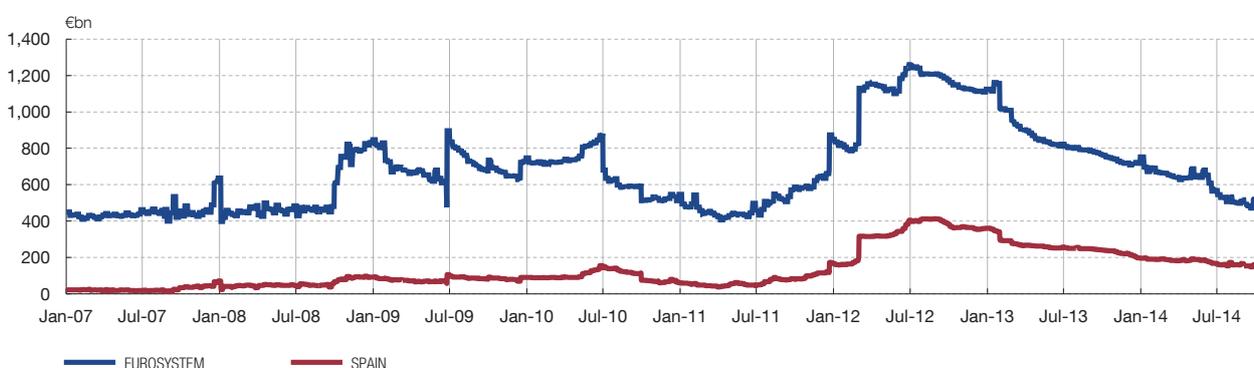
A. MAIN ISSUES OF SPANISH INSTITUTIONS IN MEDIUM- AND LONG-TERM WHOLESALE MARKETS (b)



B. EONIA TRADING VOLUME



C. OUTSTANDING AMOUNT PROVIDED THROUGH EUROSISTEM TENDERS



SOURCES: Bloomberg, Dealogic and Banco de España.

- a Latest data: 29 October 2014.
- b Senior debt and covered bond issues are included. Retained issues are not included.

Activity on the interbank markets of the euro area has remained weak, without significant changes since the last FSR

The activity of euro area interbank markets has remained weak, holding at levels below those of previous years and without any significant changes since the last FSR. Chart 2.6.B shows EONIA trading volumes. After bottoming out at the end of 2012, these have followed an upward path in 2013 and 2014, albeit relatively moderately and discontinuously. The Spanish interbank market behaved similarly.

The trend towards reducing recourse to the Eurosystem continued

Owing to the scant activity on the interbank markets, and the unlimited provision of liquidity by the Eurosystem, European credit institutions have continued to resort extensively to Eurosystem funds, although this has been compatible with an ongoing trend to reduce that recourse, which began in summer 2012. Since then, the ability of European banks to raise funds on the primary markets has improved considerably, allowing them to lower their purchases in regular operations and repay early a portion of the funds received in the two 3-year tenders (LTROs) allotted in late 2011 and early 2012. As a result, the liquidity provided by the Eurosystem has returned to levels similar to those prior to the LTROs, even taking into account the effect of the new targeted longer-term refinancing operations (TLTROs) which began to be carried out in September (see Box 2.3 for more details of the ECB's non-standard measures). Thus, between the end-October 2013 and end-October 2014, banks resident in Spain reduced their gross recourse to the Eurosystem by €76 billion (32%), while the outstanding balance in the total Eurosystem decreased by €221 billion or 30% (see Chart 2.6.C, which shows the outstanding balance of ECB tenders).

The Governing Council of the European Central Bank (ECB) has recently adopted several measures to enhance the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy.

In June 2014, it announced a series of targeted longer-term refinancing operations (TLTROs).¹ The two initial operations were scheduled for September (this one has already been carried out) and December 2014, and the additional TLTROs will be conducted in March, June, September and December 2015, and in March and June 2016. All TLTROs will mature in September 2018. The interest rate on the TLTROs, which will remain fixed over the life of each operation, will be the rate on the main refinancing operations prevailing at the time of take-up, plus a fixed spread of 10 bp. Starting 24 months after each TLTRO, counterparties will have the option to repay any part of the amounts that were allotted in that TLTRO at a six-monthly frequency.

In the first two TLTROs as a whole, individual credit institutions will be able to borrow an amount equal to up to 7% of the amount of their loans to the euro area non-financial private sector (non-financial corporations and households), excluding loans to households for house purchase, outstanding on 30 April 2014.

Thereafter, credit institutions will be able to borrow additional amounts in the subsequent TLTROs, depending on whether their eligible loans exceed a specified benchmark for each bank. Specifically, the additional amount to be borrowed is limited to three times the difference between net lending² since 30 April 2014 and the benchmark on the date on which this amount is requested. The benchmark will always be zero for credit institutions reporting positive eligible net lending in the 12 months to 30 April 2014. For credit institutions reporting negative eligible net lending in the 12 months to 30 April 2014, different benchmarks will be applied, which will be calculated as follows: (i) for the 12 months to 30 April 2015, the average monthly net lending of each credit institution in the 12 months to 30 April 2014 will be extrapolated, and ii) for the 12 months from 30 April 2015 to 30 April 2016, the benchmark monthly net lending will be zero. Institutions that have borrowed under the TLTROs but do not reach their specified benchmark as of 30 April 2016 will be required to pay back all their borrowings in September 2016.

Credit institutions may participate in the TLTROs on an individual basis. In addition, several institutions may form a “TLTRO group”,

if they fulfil certain conditions, and may participate in these operations through a group member. In this case, the benchmark and the borrowing limits for the group will be calculated on the basis of the aggregate lending data for the “TLTRO group”.

As regards eligible collateral, in the TLTROs the same collateral rules apply – in relation to eligibility criteria, valuation, haircuts and use of collateral – as in other Eurosystem liquidity-providing refinancing operations.

Credit institutions participating in the TLTROs are subject to specific reporting obligations until the end of the programme in September 2018, and to an annual examination of data accuracy.

Also, at its first meeting in September 2014, the Governing Council of the ECB decided to launch two asset purchase programmes. First, taking into account the role of the securitisation market in facilitating new credit flows to the economy, it announced a simple asset-backed securities purchase programme (ABSPP) with underlying assets consisting of claims against the euro area non-financial private sector. Second, and in parallel, the Governing Council of the ECB also announced the third programme for purchases of euro-denominated covered bonds issued by euro area credit institutions (CBPP3).

The main details of the two programmes were announced in early October. In both cases, the securities eligible for purchase will be selected from among the assets eligible as collateral for monetary policy operations, although there will be some adjustments to take into account the difference between accepting assets as collateral and buying assets outright, and to ensure that the programmes can include all the euro area countries. The two programmes will last for at least two years and asset purchases will commence in the fourth quarter of 2014, starting with covered bonds in the second half of October.³

1 Subsequently, in July, the technical details of these TLTROs were announced and the legal act which is the foundation for the series of TLTROs was published (Decision ECB/2014/34 of the European Central Bank of 29 July 2014 on measures relating to targeted longer-term refinancing operations).

2 Net lending between two specific dates is measured as the difference between the amounts of eligible loans outstanding on those dates.

3 For further operational details on these asset purchase programmes, see the annexes to the ECB press release of 2 October 2014 on this matter.

As a result of this decrease in gross recourse to the Eurosystem by both banks resident in Spain and total Eurosystem banks, the share of loans to Spanish banks in the total Eurosystem remained practically unchanged over that period, standing at an average of 31.3% in September 2014, while the share in September 2013 was 31.4%.

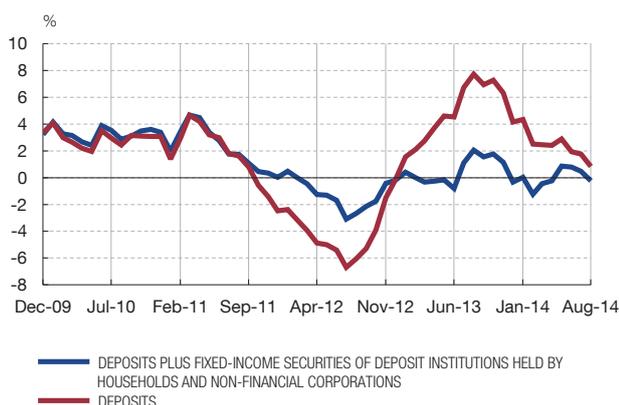
Retail funding raised by Spanish deposit institutions from deposits by households...

Retail funding raised by Spanish deposit institutions from deposits placed by households and non-financial corporations grew by 0.8% year-on-year at August 2014 (latest available data), a smaller rate of change than that at the same month a year earlier, when

DEPOSITS FROM HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS, ID

CHART 2.7

A. YEAR-ON-YEAR RATES OF CHANGE



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



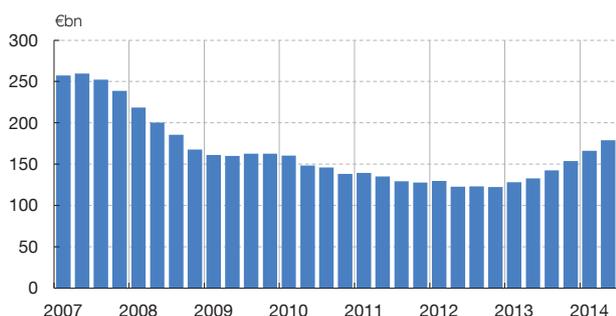
SOURCE: Banco de España.

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

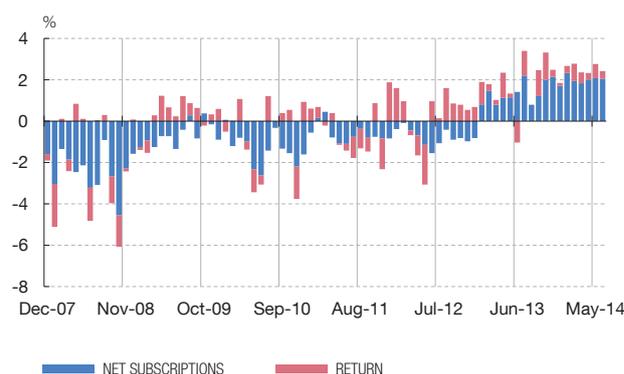
INVESTMENT FUNDS

CHART 2.8

A. ASSETS OF INVESTMENT FUNDS



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



SOURCE: INVERCO.

...and non-financial corporations grew moderately at August in year-on-year terms,...

the year-on-year growth was 7.7% (see Chart 2.7.A), but more in line with that prevailing before the negative rates of change first appeared in early 2012.

The securities issued by deposit institutions to households and non-financial corporations, which also form part of retail funds raised by banks along with household and non-financial corporation deposits, continued the decline initiated by them in June 2012, when they reached a high due to the regulatory changes relating to contributions to the Deposit Guarantee Fund based on the risks assumed (fixed income securities were not subject to such contributions). Interest in these products has gradually faded owing to subsequent regulatory changes in this respect in August 2012.

Joint analysis of the deposits and fixed income securities issued by deposit institutions to households and non-financial corporations shows that retail funding has held steady, decreasing at August 2014 by 0.2% in year-on-year terms, compared with a rise of 2% at the same month a year earlier. This slight decrease is, however, smaller than at the beginning of the year, when the rate of change was more negative.

...while the funding gap of the retail sector has continued to decrease

The stability of retail funding, along with the ongoing decline in credit, has made possible in recent years a marked trend towards a reduction of the retail funding gap of deposit institutions, i.e. the difference between lending and deposits. This trend has been continuous since 2007, with the odd sharper drop in December 2012 as a result of the transfer to Sareb of real estate assets of Group 1 banks. Since 2007 the loan-deposit gap has decreased by nearly 40% (see Chart 2.7.B).

The financial market conditions prevailing in recent months, along with a low interest rate environment, may have had an influence on economic agents' decisions about where to place their savings and on banks' marketing strategies, by raising the appeal of products which, although not perfect substitutes for bank deposits because of their high risk, compete with them in attracting those savings.

Thus, throughout 2014 the net assets of investment funds tended to increase (see Chart 2.8.A), rising by more than €25 billion in the first two quarters of 2014. This expansion arose mainly from an increase in net subscriptions (see Chart 2.8.B). The contribution from yields was also positive in all months of the year, but accounts to a lesser degree for the rise in investment funds' total net assets.

2.2 Profitability

Spanish deposit institutions recorded consolidated income of €7,886 million in the first half of 2014

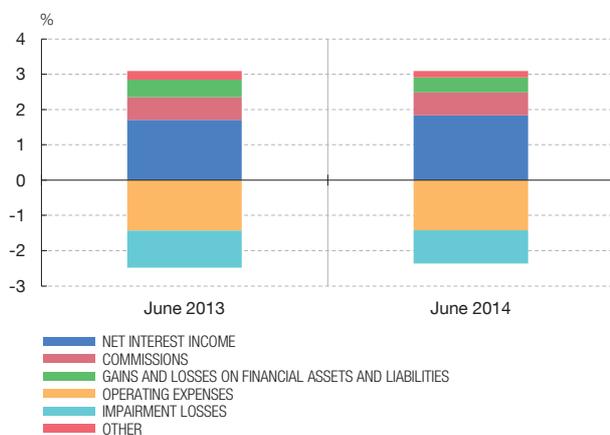
In the first half of 2014 Spanish deposit institutions recorded consolidated income of €7,886 million (see Table 2.2), short of the somewhat more than €8.2 billion in the same period of 2013 (fall of 4.6%). However, profitability in terms of assets, ROA, was 0.47% compared with 0.45% last year. Meanwhile, profitability in terms of equity, ROE, was 7%, somewhat below that of 7.8% at June 2013, largely as a result of the increase in own funds.

Profit before tax in terms of ATA increased by 12 bp from June 2013 to June 2014, when it reached 0.73%. The main factors contributing to that increase in terms of average assets (see Chart 2.9.A) were net interest income, up by 12 bp in the period, and smaller asset impairment losses, the relative weight of which decreased by nearly 10 bp between June 2013 and June 2014, meaning that they reduced operating income by a smaller percentage (see Chart 2.9.B). These factors having a positive impact on income before tax were partially offset by a decrease in the average return on financial transactions (see Chart 2.9.A).

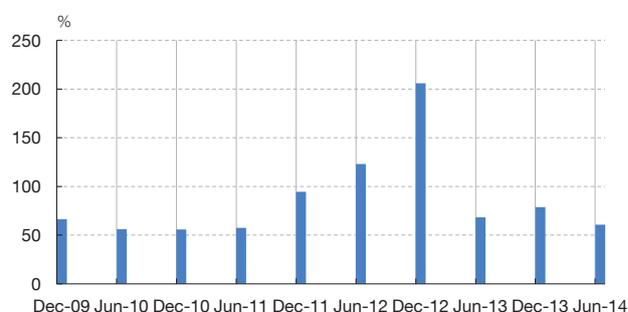
PROFITABILITY Deposit institutions

CHART 2.9

A. CONTRIBUTIONS OF THE ELEMENTS OF PROFIT BEFORE TAX AS % OF ATA



B. PERCENTAGE REDUCTION IN NET OPERATING INCOME DUE TO IMPAIRMENT LOSSES



SOURCE: Banco de España.

	Jun-14		Jun-13	Jun-14
	€m	% Change Jun-14/Jun-13	% ATA	% ATA
Financial revenue	56,091	-8.6	3.36	3.32
Financial costs	25,234	-16.3	1.65	1.49
Net interest income	30,856	-1.1	1.71	1.83
Return on equity instruments	919	43.7	0.03	0.05
Share of profit or loss of entities accounted for using the equity method	1,677	-42.6	0.16	0.10
Net commissions	11,155	-4.1	0.64	0.66
Gains and losses on financial assets and liabilities	7,021	-23.3	0.50	0.42
Other operating income	-1,375	.	-0.08	-0.08
Gross income	50,253	-7.1	2.96	2.98
Operating expenses	23,943	-8.2	1.43	1.42
Net operating income	26,310	-6.0	1.53	1.56
Asset impairment losses (specific and general provisions)	13,696	-19.2	0.93	0.81
Provisioning expense (net)	1,396	-42.4	0.13	0.08
Operating profit	11,219	30.2	0.47	0.66
Asset impairment losses (assets other than loans and receivables)	2,269	4.9	0.12	0.13
Income from disposals (net)	3,396	-26.4	0.25	0.20
Profit before tax	12,346	11.6	0.61	0.73
Net income	9,126	-3.5	0.52	0.54
Memorandum item:				
Income attributable to the controlling entity	7,886	-4.6	0.45	0.47

SOURCE: Banco de España.

Net interest income decreased
year-on-year at June 2014...

A closer look at the main income statement items shows that in the first six months of 2014 net interest income was slightly lower than in the same period of the previous year (1.1%). Although the return on investment decreased by 8.6%, the containment of the cost of financing the related assets allowed total financial costs to be reduced by 16.3% with respect to the same period of the previous year. As a result, deposit institutions ended the first half of 2014 with net interest income of more than €30 billion. Net return on investment measured in terms of ATA stood at 1.83%, against 1.71% at June 2013.

...basically due to a decrease
in activity

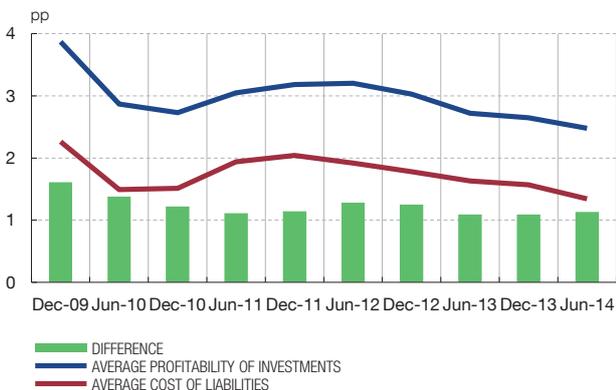
Net interest income fell more sharply year-on-year at June 2014 in business in Spain than in business abroad. The difference between the average return on investment and the average cost of liabilities held steady between June 2013 and June 2014, in contrast to what happened in the period between June 2012 and June 2013 (see Chart 2.10.A), so the fall in net interest income in Spain is basically due to lower activity, against a background of declining credit (see Chart 2.10.B). Additionally, Chart 2.10.C shows that, for new operations, the marginal rate on assets decreased by less than the marginal rate on liabilities, reaffirming the favourable tendency observed in the difference between average rates.

The gross income of deposit institutions in the first half of 2014 amounted to somewhat more than €50 billion, 7.1% less than for the first six months of 2013. Measured as a proportion of assets, gross income amounted to 2.96%, compared with 2.98% in the same period a year earlier. The main reasons for this drop in absolute value are the behaviour of net commissions and of gains (losses) on financial assets and liabilities.

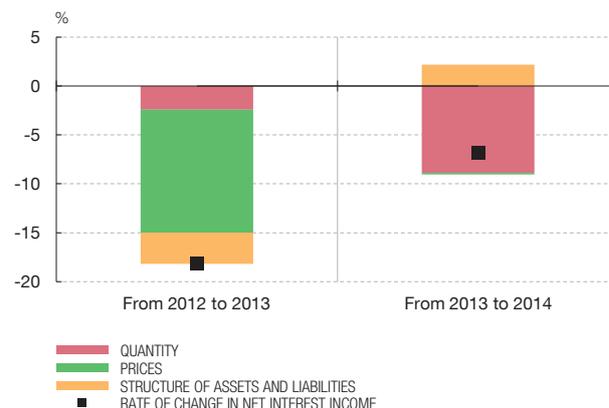
PROFITABILITY
Deposit institutions, ID

CHART 2.10

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



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



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



D. EMPLOYEES AND OFFICES, ID



SOURCE: Banco de España.

a Marginal interest rates refer to those established in transactions initiated or renewed in the previous reference month. The transactions are weighted according to their volume. The weighted marginal interest rates of assets include, among others, those applied to financing for house purchase, consumption and credit to non-financial firms, while the liabilities ones include fixed-term deposits and repos, among others.

Net commissions held steady in terms of average assets, although they decreased in absolute value between June 2013 and June 2014

The contribution of net commissions to the income statement was down slightly compared with that at June 2013 (-4.1%), although the percentage in terms of assets was practically the same. The downward trend in the volume of business may largely account for the continuous moderation in this item, since the largest fall in the period was that of commissions for collection and payment services (-6.6% between June 2013 and June 2014) and at the same time they account for a larger proportion of commission income (see Chart 2.11.A), whereas those arising from securities services and from non-bank financial product sales performed favourably, in line with the trend shown by financial products of this type (see Chart 2.8).

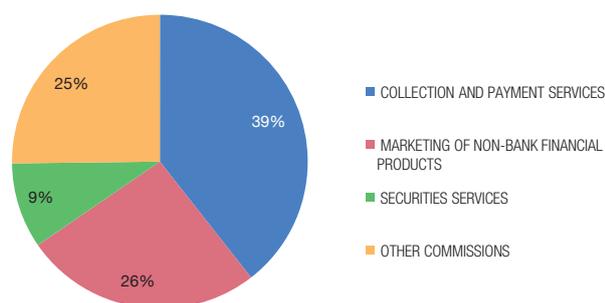
Gains and losses on financial assets and liabilities also decreased year-on-year

The other major factor in explaining the fall in gross income is gains and losses on financial assets and liabilities. Given the large volume of this item in the first half of 2013 (somewhat more than €9 billion), the more than €7 billion recorded in 2014 (60% of which came from available-for-sale assets and nearly 20% from the trading portfolio, see Chart 2.11.B) represented a decrease of 23.3% in this item with respect to the previous year.

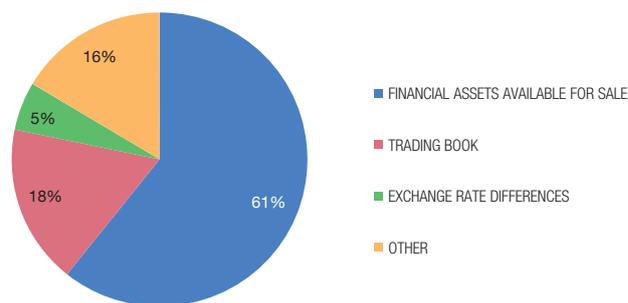
Operating expenses were cut, the number of employees...

In line with the downtrend prevailing to date, net operating income at June 2014 was down by 6% with respect to that of 2013, standing at around €26.3 billion. Operating expenses

A. BREAKDOWN OF COMMISSIONS REVENUE



B. BREAKDOWN OF GAINS AND LOSSES ON FINANCIAL ASSETS AND LIABILITIES



SOURCE: Banco de España.

...and offices decreasing in business in Spain

decreased by 8.2%⁷ with respect to June 2013. The trend initiated in 2009 of containment of operating expenses continued as a result of a reduction in the number of employees and offices, as seen in Chart 2.10.D, which shows that the levels of both variables are below those at the beginning of the past decade. The decreases with respect to the peak in 2008 are of nearly 25% in staff and of nearly 30% in number of offices. This process of operating cost containment shown by deposit institutions is expected to continue, due particularly to the compulsory nature of the restructuring plans established as a result of the European financial assistance programme for recapitalising the Spanish banking system. Operating expenses were reduced both in Spain and abroad, although more moderately so abroad.

Losses arising from asset valuation adjustments decreased with respect to June 2013...

Provisioning losses arising from valuation adjustments to assets (specific and general provisions) decreased by 19.2% with respect to June 2013. The more moderate growth of NPLs and the high provisions recorded by banks in prior periods (particularly in 2012 and, in some cases, in the first half of 2013 as a result of the accounting reclassification of forborne loans) explain this lesser need to record provisions in the first half of 2014.

...and reduced net operating income by a smaller percentage

After stringent provisioning (as a result of RDL 2/2012 and RDL 18/2012) with provisioning charges of more than twice net operating income, the current charge stands at 52% of net operating income (see Chart 2.9.B). The losses arising from impairment of assets other than loans and receivables (including those arising from provisions for losses on foreclosed assets) increased slightly compared with those at June 2013. Specifically, they increased by 4.9% to €2,269 million.

In short, deposit institutions managed to withstand the pressure put on their income statements by very low interest rates, smaller volumes of business and a still-high level of non-earning assets. They have done so by the containment of operating costs and the lower provisions made possible by more moderate increases in NPLs. In that setting, with limited room for manoeuvre, a policy of cost containment and increased efficiency must act as the guiding principle for banks in the near future so they can sustain their profitability levels.

⁷ This year-on-year fall is sharper due to the staff adjustment processes of various banks in 2013, which had their strongest impact on operating expenses in that year.

2.3 Solvency

Basel III has been transposed to European legislation through Directive 2013/36/EU of 26 June 2013 and Regulation (EU) 575/2013 of 26 June 2013

2014 saw the first-time application of the new prudential standards on solvency issued by the Basel Committee, generally known as Basel III. Basel III builds on Basel II (Banco de España Circular 3/2008), modifying some of its elements and, in particular, adding new prudential tools. Basel III has been transposed into European legislation through Directive 2013/36/EU of 26 June 2013 (incorporated into Spanish law through Law 10/2014 of 26 June 2014 on the regulation, supervision and solvency of credit institutions, which will subsequently be implemented via a royal decree and a Banco de España circular) and Regulation (EU) 575/2013 of 26 June 2013⁸ (directly applicable in Member States).

As regards regulatory capital, the basic objectives of the new legislation are not only to establish higher own funds requirements for banks, but also to improve the quality of their own funds, i.e. their capacity to absorb losses. Other additional objectives are to establish internationally uniform definitions of capital and to enhance transparency.

The new legislation on own funds establishes two levels of capital: tier 1 and tier 2. The former includes common equity tier 1 (CET1), which is the category with the highest quality. The quality of capital has been improved by tightening the requirements for eligible instruments to count as CET1 and by extending the deductions of items not qualifying as CET1.⁹

The new solvency requirements ensure the quality of common equity and thus considerably enhance its capacity to absorb losses, which is the primary purpose of the new capital regulation

The new requirements ensure the quality of common equity and therefore considerably enhance its capacity to absorb losses, which is the prime purpose of the new capital regulation. Although to a lesser extent, improvements are also made in the capture of risk, the denominator of the capital ratio, thereby tightening particularly the treatment of risk arising from the trading portfolio.

Another way of increasing banks' capacity to absorb capital losses is through the modification of the required minimum thresholds. In this connection, Basel III has substantially increased the regulatory ratio for common equity. The new legislation introduces a specific new capital requirement based on CET1, which is set at 4.5% and will rise to 7% when the capital conservation buffer is applied in full.¹⁰ Note that another series of buffers is established, such as the requirements for systemically important banks (see Box 2.4) which, as and when they are activated, could raise the minimum regulatory requirements above that 7%. Also, other macroprudential tools, such as the counter-cyclical buffer (see Chapter 4) or the systemic buffer, are made available to the competent authorities.

Given the aforementioned requirements, CET1 has become the market benchmark for judging bank solvency, while additional tier 1 capital (AT1) and tier 2 capital are tending to be given less importance.

The total tier 1 capital requirement (CET1 + AT1) for regulatory purposes is set at 6% and the total capital requirement (tier 1 and tier 2) is set at 8%, i.e. maintaining the original Basel II requirement. Finally, banks will adapt gradually to the new legislation, completing the process at the beginning of 2019.

⁸ As well as the Binding Technical Standards (BTS) of the European Banking Authority on specific aspects of the legislation.

⁹ For example, according to the new legislation the items which must be deducted in full from CET1 (although, due to transitional adjustments, deduction in full will not generally take place until 2018) are: goodwill and other intangible assets, deferred tax assets that rely on future profitability and holdings of own shares including contractual obligations to purchase own shares.

¹⁰ The envisaged implementation schedule specifies that the capital conservation buffer shall be 0.625% in 2016, 1.25% in 2017, 1.875% in 2018 and, as its definitive level, 2.5% from 1 January 2019.

Article 131 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 (CRD IV), transposing Basel III into EU legislation, sets out additional capital requirements for institutions classified as global systemically important institutions (G-SIIs).

In accordance with Article 131, a methodology shall be developed to identify systemically important institutions and classify them into five different buckets on the basis of their systemic importance. The lowest bucket shall be assigned a specific capital requirement of 1% of the total risk exposure amount. The requirement shall gradually increase in tranches of 0.5 pp up to a potential level of 3.5% for the highest bucket of G-SIIs.

Since the approval of Basel III, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) have been working together on developing and assessing a methodology for the identification and categorisation of systemically important institutions.¹

The methodology developed by the BCBS and the FSB determines that competent authorities may exercise their supervisory judgment to classify any institution belonging to the initial population² as systemically important even if, using the established quantitative method, the institution does not reach the cut-off score of the lowest bucket (additional capital surcharge of 1%).

The score is an average of five variables or indicators, namely size, interconnectedness, substitutability/infrastructure, complexity and cross-border activity, each of which receives an equal weighting.

The size indicator is the exposure measure defined for the leverage ratio under Basel III (December 2012 definition). The interconnectedness indicator is based on intra-financial system assets and liabilities and on financial instruments outstanding. The substitutability/infrastructure indicator relies on each bank's payments activity, assets under custody and underwriting of financial instruments; the contribution of the substitutability/infrastructure indicator to the total G-SII score is capped at 500 bp.

The complexity indicator is determined by positions in OTC derivatives, by the total amount of the trading book and available-for-sale securities and, finally, by level 3 assets.³ The cross-border activity indicator is based on cross-jurisdictional claims and liabilities.

For each bank, the score for a particular indicator is calculated as the ratio (in basis points) of the relevant variable – for example, exposure – to the aggregate amount of that variable for all the banks in the sample. If an indicator is based on more than one variable, the score is calculated as the simple average of the individual scores of each constituent variable.

Institutions are grouped into buckets on the basis of their total G-SII score: those with a score below 130 bp are excluded from the G-SII category, while those that score over 130 bp are grouped into the G-SII buckets (bucket 1 and above) based on successive 100 bp increases over that minimum threshold.

The classification by buckets resulting from the scores obtained based on this methodology and supervisory judgment at end-2013, which will be published shortly by the FSB and the BCBS, will determine the additional capital requirement to increase the loss-absorbing capacity of systemically important institutions, which will be phased in progressively between 2016 and 2019. In other words, if an institution is included in the first bucket with an additional capital requirement of 1% in 2016, its minimum capital ratio will increase by 0.25 pp in that year, and by 0.25 pp in each of the three subsequent years.

¹ The methodology published by the Basel Committee is available at <http://www.bis.org/publ/bcbs207.pdf>.

² The BCBS requires that banks with exposure exceeding €200 billion at end-2012 submit the information needed to compute their score as G-SIIs.

³ Level 1 assets are those valued using quoted prices in active markets that the institution can access. Level 2 assets are measured using inputs other than quoted prices that are directly or indirectly observable. Prices of level 3 assets are unobservable.

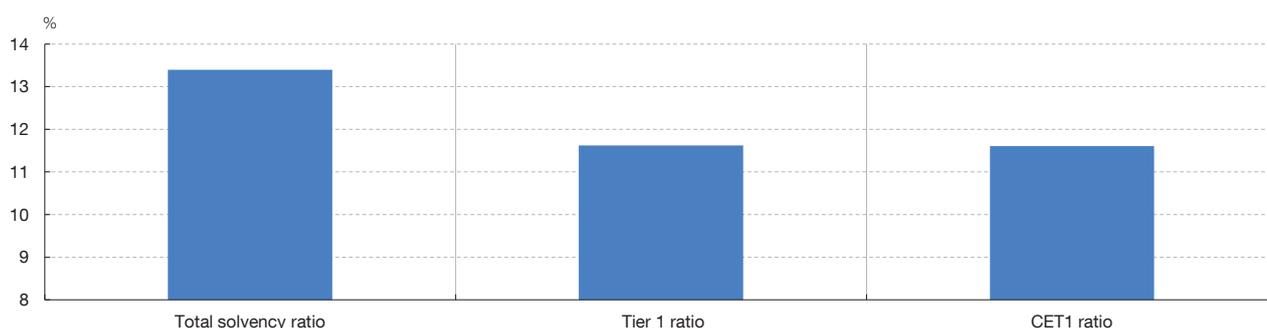
The common equity tier 1 (CET1) ratio of Spanish deposit institutions at June 2014 at aggregate level was 11.6%, amply exceeding the regulatory requirement

The information given below is drawn from the first prudential reporting by Spanish banks under the new regulatory framework.¹¹ It shows that the common equity tier 1 (CET1) ratio of Spanish deposit institutions at June 2014 at aggregate level was 11.6% (see Chart 2.12). This ratio amply exceeds the regulatory requirement stated above. The ratio takes into account the transitional adjustments conceived to facilitate its progressive application.¹² The tier 1 capital (CET1 + AT1) ratio was the same (11.6%) due to the effect of the gradual transitional adjustments, particularly those relating to deductions.¹³ The implementation schedule

¹¹ Since it is the first prudential reporting upon the entry into force of the new regulatory framework, an inter-period comparative analysis cannot be made.

¹² In accordance with the provisions of Circular 2/2014 on the exercise of various regulatory options contained in Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

¹³ The main transitional adjustments in quantitative terms relate to the deduction of intangible assets and the next most important ones concern the deduction of deferred tax assets that rely on future profitability.



SOURCE: Banco de España.

generally specifies that in 2014 only 20% of these amounts is to be deducted from common equity and that the other 80% is to be deducted from additional tier 1 capital. Furthermore, the total capital ratio of 13.4% was also above the regulatory requirement (see Chart 2.12).

The capital metrics indicate that the type of capital which has been most strengthened is that of higher quality, i.e. common equity tier 1 (CET1)

In absolute terms, the amount of CET1 in excess of the regulatory requirement stands at more than €100 billion, while in terms of total capital this excess is around €89 billion (see Chart 2.13.A). The capital metrics indicate that the type of capital which has been most strengthened is that of higher quality, i.e. common equity tier 1 (CET1), in line with the closer attention it receives from regulators and from the market. Thus CET1 represented 87% of total capital (see Chart 2.13.B). Meanwhile, under the new regulatory criteria for measuring risk exposure, Spanish deposit institutions had aggregate risk-weighted assets of €1,651 billion at June 2014 (see Chart 2.13.A), amounting to 47% of their total assets.

Within regulatory capital, equity instruments are the most significant item along with reserves, while the main deductions are those associated with goodwill and other intangible assets

Looking at the composition of common equity, as regards regulatory capital, the quantitatively most significant items are equity instruments (47%) and reserves (26%). Next come transitional adjustments (20%), an item which will persist for the period of application of the transitional provisions set out in Part 10 of the EU Regulation. Minority interests and other items account for 6%. As regards deductions, the main items are those relating to goodwill and other intangible assets (52%), followed by deferred tax assets (17%) and other deductions (31%). Chart 2.13.C shows this structure in terms of risk-weighted assets.

Finally, turning to the composition of risk-weighted assets, credit risk is clearly the main component (85%). Operational risk (10%) and position, exchange rate and commodity risk (5%) are the next most important in quantitative terms, while other risks account for less than 1% of risk-weighted assets (see Chart 2.13.D).

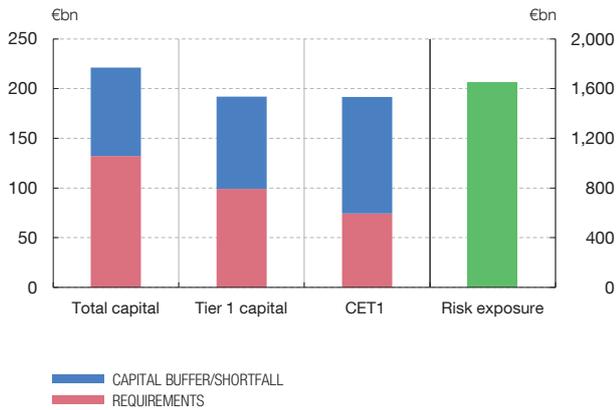
The usual market indicators show that the share prices of Spanish banks performed favourably throughout 2014, while their price-to-book ratios continue to improve

The usual market indicators show that the share prices of Spanish banks performed favourably throughout 2014. All of them posted gains and most of them performed more strongly than their European peers, which advanced more unevenly (see Chart 2.14.A). As a result of this favourable performance, the price-to-book ratios of Spanish banks continued to improve. As regards this metric, some Spanish banks are in strong positions with respect to their European peers, while others are in an intermediate position (see Chart 2.14.B). Box 2.5 compares the main Spanish banks (those directly supervised by the ECB from 4 November 2014) with those directly supervised by the ECB in other euro area countries.

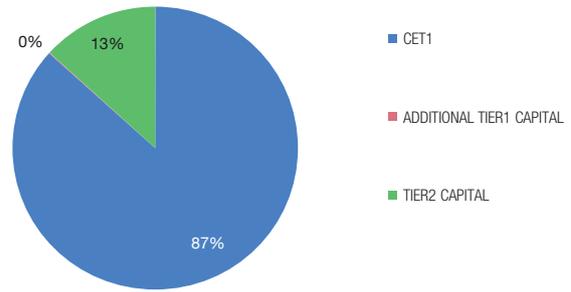
BREAKDOWN OF OWN FUNDS AND RISK-WEIGHTED ASSETS
Deposit institutions. June 2014

CHART 2.13

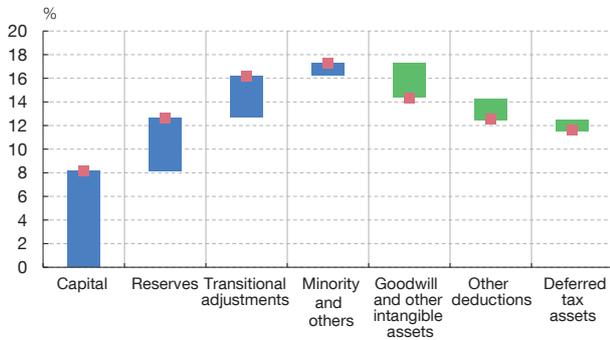
A. LEVELS OF CAPITAL AND RISK EXPOSURE (right-hand scale)



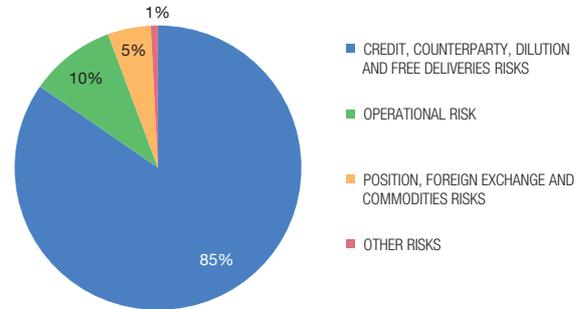
B. BREAKDOWN OF OWN FUNDS



C. BREAKDOWN OF CET1 RATIO AS % OF RWA



D. BREAKDOWN OF RISK-WEIGHTED ASSETS

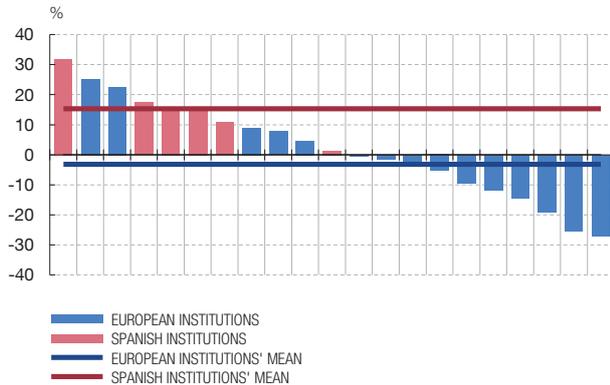


SOURCE: Banco de España.

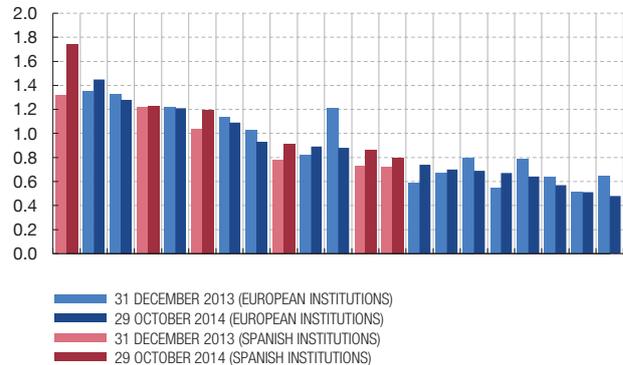
MARKET INFORMATION
International comparison (a)

CHART 2.14

A. STOCK MARKET CHANGE BETWEEN 31 DECEMBER 2013 AND 29 OCTOBER 2014 (b)



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



SOURCE: Datastream.

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

On 4 September the ECB published the list¹ of significant banks that will be directly supervised by the ECB in the framework of the SSM. This box, based on information obtained directly from the SNL Financial database² as at December 2013, contains a comparative analysis of the banks directly supervised by the SSM, with the data aggregated at the country level.³

In terms of total assets of the banks directly supervised by the SSM, the Spanish banks account for 14.5% of the total, in third place behind France (31.6%) and Germany (21%) (see Panel A) and ahead of Italy (10.6%) and the Netherlands (9.1%). These five countries account for 87% of the assets to be directly supervised by the SSM, with the remaining 13% being divided between the other 13 countries. In terms of customer loans and deposits, the relative weight of Spain's banks (18.5% in loans and 20.4% in deposits) has increased, placing them second behind France and ahead of Germany. This is due, in part, to the different balance sheet structures of the banks. For example, loans to customers account for almost 60% of assets in Spain (and Italy), while in France and Germany the figure is around 36%. Likewise, customer deposits account for 55% of assets in Spain, while in France and Germany the figure is around 32%.

In terms of profitability, in 2013 the overall net income obtained by the Spanish banks directly supervised by the SSM amounted to approximately €13 billion, in comparison with the substantial losses recorded in 2012. This figure places them second in Europe, topped only by the French banks whose net income amounted to more than €17 billion. Overall, the banks directly supervised by the SSM for which SNL Financial has data available posted net income

of less than €16 billion in 2013, negatively affected by losses in the Irish, Cypriot, Slovenian and Portuguese banks, and particularly in the Italian banks which recognised losses of more than €21 billion. In 2013 the Spanish banks topped the euro area ranking in terms of return on equity (ROE, defined as net income/total equity; see Panel B). They also held a leading position among the main European countries on cost/income ratio (operating expenses/gross operating income) (see Panel C).

In the case of solvency, the core Tier 1 ratio of the Spanish banks as at December 2013 in accordance with the solvency regulations in force in 2013 (11.7%) was medium/low in comparison with the euro area countries, just short of the European average (11.9%), very close to the French figure and ahead of Italy (see Panel D). However, in terms of leverage (total equity/total assets) the opposite is the case, as Spain's figure of 6.8% is 1.5 pp above the European average (see Panel E).

In terms of the ratio of provisioning to customer loans, the provisioning rate of Spain's banks (5.6%) is almost 1 pp higher than the European average (4.7%), below the coverage rates of Italy and Portugal but above those of France and Germany (see Panel F).

Lastly, the hypothetical credit rating⁴ of the group of Spanish banks directly supervised by the SSM (Baa3 according to Moody's and BBB- according to Standard & Poor's, which in both cases is the step immediately above speculative or high-yield, and between BBB and BBB+ according to Fitch, which is two or three steps above that level) would be between two and three steps below the credit rating of all the banks directly supervised by the SSM overall (between A3 and Baa1 according to Moody's, A- according to Standard & Poor's, and between A and A- according to Fitch). The difference largely reflects the different sovereign risk ratings across the European countries.

To sum up, the Spanish banks directly supervised by the SSM, which account for 90% of the total assets of Spain's deposit-taking institutions, hold a leading position in terms of profitability and cost/income vis-à-vis the banks of other European countries. Their solvency ratios are below the European average, but they have lower levels of leverage.

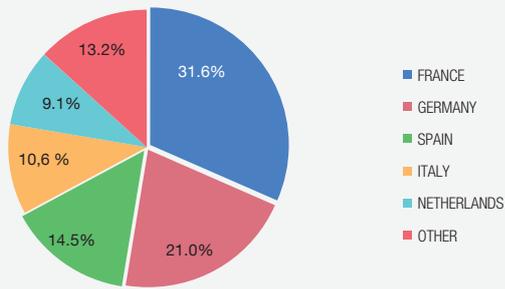
1 <https://www.ecb.europa.eu/pub/pdf/other/ssm-listofsupervisedentities1409en.pdf?59d76de0c5663687f594250ebf228c6b>.

2 The coverage provided by SNL Financial differs according to the variables considered, ranging from data available for 111 of the 120 banks in the case of assets and income, to data available for 99 banks in the case of loan provisioning. Accordingly, the quantitative analysis must be viewed with some caution. The definitions of the variables and the concepts included in each variable do not coincide exactly with those used in the results from the Comprehensive Assessment included in Chapter 3. For example, the core Tier 1 ratio as at December 2013 contained in SNL is that published by the banks in accordance with the legislation applicable in 2013, while that recently published in the Comprehensive Assessment includes the current regulations for the CET1 ratio as at December 2013, which means that they are not directly comparable.

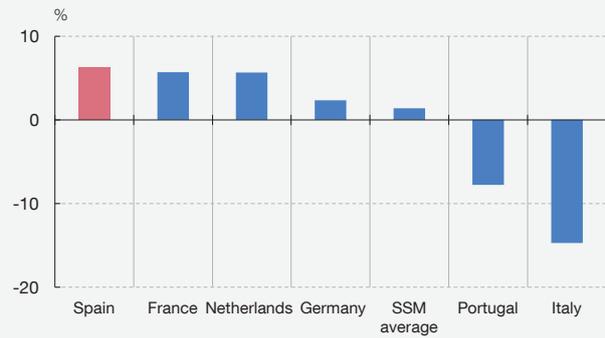
3 The list of 120 entities includes 21 German banks, 15 Spanish banks, 14 Italian banks, ten French banks, eight Austrian banks, seven Dutch and seven Belgian banks, five Luxembourg banks, four Portuguese, four Irish, four Greek and four Cypriot banks, three Finnish, three Slovenian, three Slovakian, three Latvian and three Maltese banks and two Estonian banks.

4 Calculated on the basis of the credit ratings, assigned by each credit rating agency for each bank, included in early September in SNL Financial, aggregated by weighting each bank by its total assets as at December 2013, both for the Spanish banks overall and the European banks overall.

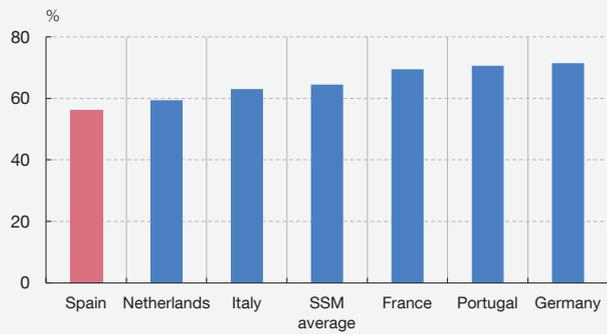
A. RELATIVE WEIGHT OF THE BANKS DIRECTLY SUPERVISED BY SSM. DECEMBER 2013



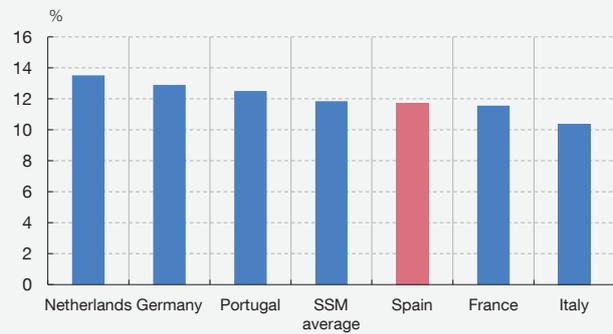
B. ROE. DECEMBER 2013



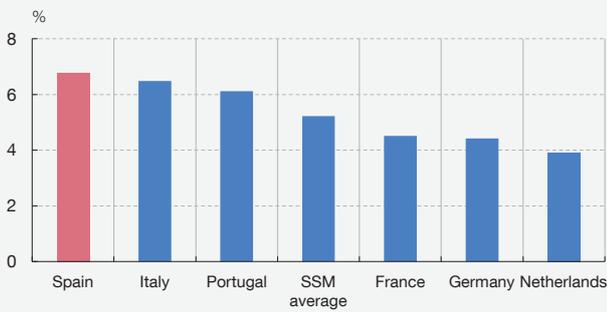
C. EFFICIENCY RATIO. DECEMBER 2013



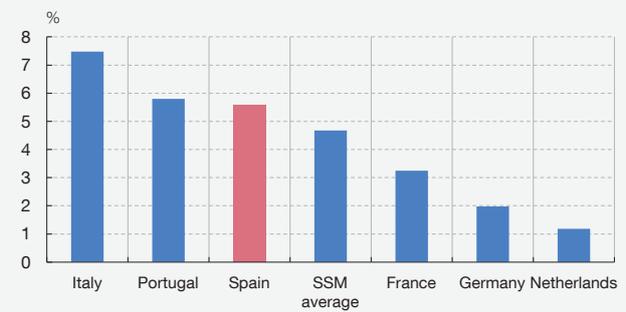
D. CET1 RATIO. DECEMBER 2013



E. TOTAL EQUITY AS % OF TOTAL ASSETS. DECEMBER 2013



F. RESERVES AS % OF CREDIT. DECEMBER 2013



SOURCE: SNL Financial.

3 COMPREHENSIVE ASSESSMENT OF THE EUROPEAN BANKING SYSTEM

The ECB has assessed the euro area banking sector, as a prior step to the start of the SSM

Between November 2013 and October 2014, the ECB performed a detailed assessment of the euro area banking system, in preparation for assuming responsibility for supervision in November 2014 within the framework of the SSM. The assessment had three main goals:

- To achieve greater transparency in the balance sheets of European banks to facilitate a more correct assessment of their solvency.
- To identify and implement any corrective measure necessary to ensure solvency in the short term.
- To restore confidence in the European banking system.

This comprehensive assessment process is based essentially on two pillars:

The process consists of an asset quality review ...

- An asset quality review (AQR), which aims to enhance the transparency and knowledge of the banks' exposures, including an assessment of the level of provisioning to correct asset impairment and a reassessment of collateral valuation.

... and a stress test

- A stress test, in collaboration with the EBA, that was designed to assess the resilience of the banks, that is, their solvency, understood as their capacity to absorb future losses under two scenarios, one baseline and one adverse.

The ECB performed this comprehensive assessment in collaboration with the national supervisory authorities

The ECB performed this assessment in close collaboration with the national supervisory authorities, within the framework of the SSM. The exercise covered 130 credit institutions in 18 Member States plus Lithuania, with a total volume of assets of more than €22 trillion.

Once the assessment was complete, the main results obtained were published in an aggregate report, with data on each institution assessed, along with the pertinent supervisory recommendations according to the results obtained. This chapter deals first with the basic elements of the assessment exercise, before analysing the main outcomes.

3.1 Details of the basic elements of the comprehensive assessment exercise

The reference date taken for the AQR was December 2013. The exercise was very broad in scope and included various kinds of risks, exposures and borrowers (exposures to domestic borrowers and exposures arising from banks' business abroad, both within and beyond the euro area).

3.1.1 ASSET QUALITY REVIEW

The main focus of the AQR was to analyse the balance sheet items that posed the most risk for banks, together with those that were least well known or least transparent.

The AQR focused on the highest-risk, least well-known and least transparent balance sheet items, applying certain minimum coverage criteria

In order to ensure that a significant part of credit institutions' balance sheets was analysed, certain minimum coverage criteria were employed at the bank level (50% of risk-weighted assets). The sampling of the portfolio selections was also subject to minimum requirements. Given the numerical nature of the exercise, a data integrity validation was also undertaken to ensure the quality and consistency of the data.

The AQR exercise¹ had two key phases: portfolio selection and execution.

First phase: portfolio selection	The first phase was essential to ensure that exposures with the highest risk were subject to in-depth review. In this phase, the national supervisory authorities proposed the portfolios to be reviewed, for each institution and on the basis of the most appropriate risk assessments. As indicated above, these proposals were subject to minimum coverage criteria. The portfolio selections proposed by the national authorities were then reviewed by the ECB, not only on the basis of information arising from supervisory data, but also on the basis of macro-financial analysis and other information obtained from a specific exercise conducted on the selected portfolios.
Second phase: execution, which in turn consisted of several stages:	Once the exposures to be assessed had been selected, the AQR was performed in several stages:
review of processes,...	First, the review of processes, policies and accounting was carried out to ensure that the banks had a clearly defined set of policies and processes for the correct interpretation of accounting rules or other kinds of similar standards in areas where possible errors of interpretation in asset valuation were most likely to arise.
... data integrity validation,...	This was followed by the validation of the integrity of the databases created by the banks specifically for this exercise, using a series of automatic verifications designed by the ECB.
... sampling,...	Before being reviewed the credit files were sampled, using statistical techniques and in accordance with international audit standards. The goal was to ensure the viability of the exercise, reducing the size of the exposure to be analysed.
... review of credit files, provisioning levels and collateral,...	A key part of the AQR exercise was to verify that the loans in the selected portfolios were correctly classified and that the provisioning levels were appropriate. The aim was to detect any possible errors in the classification of exposures, which might be assigned to the wrong portfolio or incorrectly classified as performing or non-performing. The analysis also included ascertaining whether there was adequate specific provisioning and, therefore, identifying whether the assets (and, where appropriate, impairment thereof) were correctly valued. Additionally, the collateral provided was also analysed, to ensure that it was correctly valued.
... extrapolation of findings, ...	The findings from the credit file review were projected from the sample to the rest of the selected portfolio, using the agreed accounting extrapolation criteria.
... calculation of collective provisioning,...	The next step was the calculation of collective provisioning, analysing both in qualitative and quantitative terms the method used to assess the level of each bank's collective provisioning requirements (provisions whose aim is to cover losses incurred but not yet reported in a specific transaction, although for the purposes of the exercise, specific-provision coverage of retail portfolios was also included in collective provisioning). The (collective) provisioning levels were compared with a model developed by the ECB; where significant differences in these levels were identified and not justified, additional provisioning was required.

¹ Details of the AQR methodology are available on the ECB website: <http://www.ecb.europa.eu/pub/pdf/other/assetqualityreviewphase2manual201403en>.

... review of level 3 assets, foreclosed assets, and ...

The process also included a review of level 3 assets, which was focused on ensuring that, in view of the nature of these exposures, the banks were correctly calculating their fair value. Foreclosed assets were also reviewed.

... final CET1 adjustment

The last stage consisted in collating the findings, to ensure that they were consistent and comparable across portfolios and banks and to determine the impact (including possible adjustments) that the results of the different stages of the execution phase might have on CET1 as at December 2013, which was the starting point for the stress testing exercise.

Both the CET1 adjustments resulting from the analysis and the most significant findings from the AQR were incorporated into the stress testing exercise

In addition to the CET1 adjustments, the most important and significant findings from the AQR were also incorporated into the stress testing exercise, particularly the findings that had an impact on fundamental elements such as the probability of default, loss-given default and provisioning levels. These adjustments – the Join-up – are described below.

Strict quality assurance in the AQR

Lastly, to ensure that the AQR was consistent throughout, a strict quality assurance policy was followed. The aim was to ensure not only that the process was appropriate but also that it was applied consistently to all the banks involved, to be certain that they were all treated equally.

3.1.2 STRESS TESTING OF EUROPEAN BANKS

The stress tests were conducted in coordination between the ECB, the EBA (design of the methodology, data centralisation, publication of results), the ESRB (design of the adverse macroeconomic scenario), the European Commission (design of the baseline macroeconomic scenario) and the national supervisory authorities which provided support for the exercise (data compilation, management and supervision of the exercise, interaction with the banks, quality assurance and consolidation of findings).

3.1.2.1 Scenarios

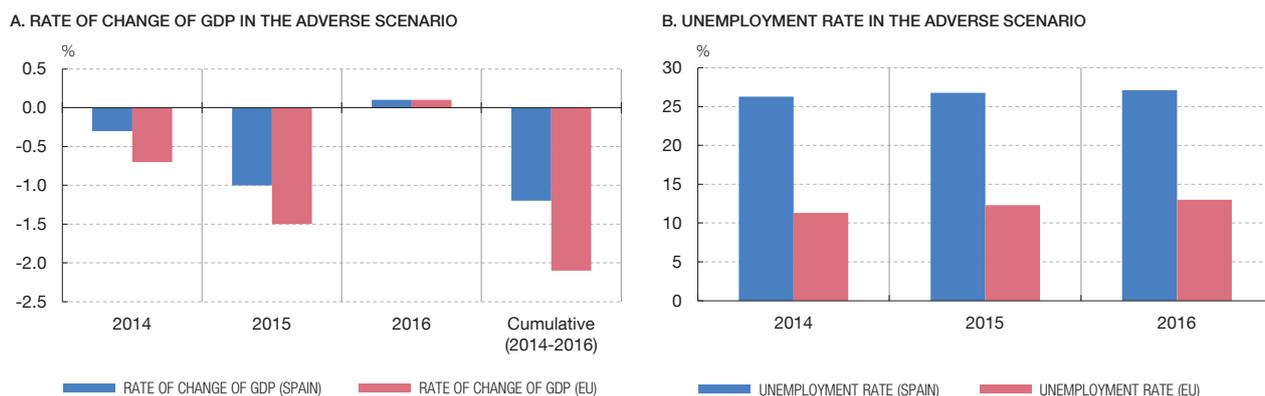
The exercise considered two scenarios, one baseline and one adverse, both over a three-year horizon (2014-2016; see Charts 3.1.A and B). The adverse scenario reflects, for the whole of the EU, a cumulative decline in the rate of change of GDP of 2.1%, an unemployment rate of 13% in 2016 and long-term government bond yields around 4.4%.

In the case of Spain, the adverse scenario was a cumulative decline in the rate of change of GDP of 1.2% over the three-year horizon, an unemployment rate of 27.1% in 2016 and long-term government bond yields in the area of 5.6%.

The baseline scenario for 2014 and 2015 was based on the European Commission's 2014 winter forecasts; for 2016 a specific model was built.

The adverse scenario did not reflect supervisory expectations, but was rather an extreme but possible scenario, with a low possibility of occurrence, scenario that could result if certain systemic risks were to materialise in the banking sector

It is important to note that the adverse scenario did not reflect European banking supervisors' core expectations, but was rather an extreme but possible scenario, with a low possibility of occurrence, that could result if certain systemic risks were to materialise in the banking sector. In particular, the adverse scenario reflected an increase in investor risk aversion, which would trigger an overall increase in the returns required of long-term investments (including government bonds) and asset depreciation, especially in emerging countries. This adverse impact would be further fuelled by credit impairment in countries with weak domestic demand and a weak banking sector, and by a slowdown in structural reforms and the need to rationalise banks' balance sheets.



SOURCE: EBA.

3.1.2.2 Capital thresholds

CET1 is used to measure solvency, with minimum ratios of 8% and 5.5% required under the baseline and the adverse scenario, respectively

In the stress tests, CET1 is the measure used to assess the solvency of the participating banks. Specifically, the target ratio used in the exercise is the CET1/RWA (risk-weighted assets) ratio, calculated using the current regulatory definition (current regulations and Capital Directive). The capital elements subject to transitional provisions are identified separately and publicly disclosed. The minimum capital requirement ratios under the baseline and the adverse scenario are 8% and 5.5%, respectively; these thresholds must be met after a capital benchmark of 8% has been met in the AQR.

3.1.2.3 Methodology

Each bank has conducted its own stress test (bottom-up approach) using a common methodology

The stress testing exercise follows a bottom-up approach, with each bank conducting the stress test using the common methodology for all institutions published by the EBA.² This methodology determines how to calculate the impact on capital of credit risk, market risk, securitisations, the cost of funding and the performance of the profit and loss account.

Credit risk

Under the stress tests, banks had to apply the macroeconomic scenarios to future loan losses over the 2014-2016 horizon, using statistical and econometric models that link the macroeconomic variables with the main elements that determine credit risk in the banks' portfolios, i.e. probability of default (PD) and loss-given default (LGD). The projected rates were used to calculate default flows and, consequently, the provisions needed to cover the credit impairment. For its part, the ECB provided the institutions with credit benchmarks based on a statistical model of its own, with aggregate data at country level adjusted to a sufficiently conservative confidence level. Banks that did not have their own credit models, or whose credit models were not appropriate, had to use the results obtained with the ECB's model.

Static balance sheet

The exercise was based on the assumption of static balance sheets as at end-2013. In other words, it was not possible to grant new loans, or to remove non-performing assets from the balance sheet, or to alter the maturities structure (replacing matured exposures with others with the same characteristics), unless a restructuring plan had been approved by the European Commission before January 2014. In any event, the calculation of RWAs for the period 2014-2016 had to reflect the deterioration in credit quality and, essentially for this reason, RWAs for credit risk could not be expected to remain constant.

² Details of the methodology used and the variables in the baseline and adverse scenarios for each of the countries included in the exercise are available on the EBA's website: <https://www.eba.europa.eu/-/eba-publishes-common-methodology-and-scenario-for-2014-eu-banks-stress-test>.

Market risk	In general, banks with limited market activities (without VaR models for their portfolios, with capital requirements for market risk below 5%) had to use a simplified market risk approach (losses based on the historical standard deviation of net income from the trading book). Banks with more market activities had to use an advanced approach to calculate losses and adjustments to RWAs based on the revaluation of their trading book and their available-for-sale and fair value portfolios, in keeping with the market scenarios prepared by the ECB and the ESRB that are consistent with the macroeconomic scenarios. The advanced approach could not, in any circumstances, be less conservative than the simplified approach, as “floors” were established on losses. Moreover, no gains were allowed.
Securitisations	Deterioration in exposures towards securitisation on the loan portfolio were calculated by applying the credit risk methodology to the underlying assets and adding in the guarantees and other characteristics of the securitisation agreements.
Sovereign risk	In the case of sovereign exposures (loans to the public sector and fixed income in the held-to-maturity portfolio), losses were applied based on probability of default (PD) and loss-given default (LGD) provided by the ECB, consistent with the macroeconomic scenarios. Sovereign exposures in the available-for-sale and fair value portfolios were stressed by applying the market risk parameters and haircuts set by the ECB and the ESRB, in all cases in accordance with the adverse scenario. In the case of the available-for-sale portfolio, applying the prudential filters agreed at the level of the Governing Council of the ECB, only 20% of the losses and gains from sovereign exposures affected capital in 2014, followed by 40% in 2015 and 60% in 2016.
Profit and loss account	<p>The static balance sheet hypothesis means that the profit and loss account, and specifically the calculation of net interest income over the 2014-2016 horizon, was essentially based on the projected interest rates for different kinds of loans and deposits. Banks had to draw up their own projections, being advised to reflect both macroeconomic factors (reference rates, market structure, etc.) and idiosyncratic factors (individual credit quality). Under the methodology used, there had to be a difference between the interest rates applied to positions existing in 2013 and those applied to new positions (renewals of matured transactions) in the course of the exercise (for example, the cost of wholesale funding, corporate deposits and retail deposits had to reflect at least 100%, 50% and 30%, respectively, of the increase in sovereign yields).</p> <p>A further series of income and cost items was also projected by the banks, under the constraint that income (costs) did not increase (decrease) in comparison with the 2013 level. Banks that did not have their own projection model had to use the historical average of their asset-related ratios to estimate income, choosing the most adverse ratios in the recent past in each case.</p>
3.1.2.4 Quality assurance	During August and September 2014, the ECB, with the collaboration of the national supervisors, performed exhaustive quality assurance of the stress test outcomes for each bank. In this process, the findings for each bank relating to credit risk, market risk, securitisations, net interest income and the profit and loss account were subjected to highly detailed checks. This was, in effect, a top-down review of the bottom-up exercise performed by the banks.
Comprehensive validation of stress test outcomes	Thus, the ECB compared the risk parameters used by the banks arising from the AQR. It also compared the benchmark parameters in its internal models with the loss reported by

each bank on each loan portfolio and performed an in-depth income and costs review, for which it also has its own model.

The ECB also reviewed the models used by the banks to estimate risk parameters, including their statistical properties, reviewing the variables included (significance and expected signs) and the goodness of fit of the estimates (R squared, Durbin-Watson, etc.).

Lastly, the ECB compared the findings for each bank with the average of the banking sector of each country, making a painstaking analysis of the institutions with the largest deviations (less capital consumption).

Quality assurance process: interplay between individual banks and supervisors which in many cases gave rise to changes in the original reports produced by the banks

Any deviations identified in the quality assurance process between the values estimated and reported by the banks and the benchmark values proposed by the ECB gave rise to demands for rectification, or for reasonable arguments to be made justifying the banks' results in comparison with those estimated and proposed by the ECB. Specifically, if the deviations arose from a direct breach of the EBA methodology, the values reported by the institution were automatically replaced by the benchmark values proposed by the ECB, with the corresponding re-submission of the corrected calculations by the bank. In the case of quantitative deviations that did not directly breach the methodology but that had a significant impact on the final CET1, the banks concerned had to submit evidence justifying their results, in all cases in accordance with the rules laid down by the ECB, and if the explanations were unsatisfactory for the ECB, banks had to make the adjustments required to match the benchmark values. Quality assurance was a three-way process between individual institutions, the national supervisors and the ECB and, where appropriate, resulted in changes being made to the original reports produced by the banks.

3.1.2.5 Join-up process: validated stress test outcomes joined up with the results of the AQR

To complete the exercise, the validated stress test outcomes had to be joined up with the results of the AQR. As indicated earlier, the results of the AQR implied changes in the starting level of CET1 for the stress testing exercise, and they were also used to adjust the projections of some of the key elements of the stress tests, such as the probability of default (PD) and loss-given default (LGD). Thus, reclassifying loans from performing to non-performing raised the starting level of PD in the stress tests, which in turn meant increasing projected PD, in the corresponding proportion, over the time horizon considered. All of which ultimately led to an overall adjustment of the final results, the impact of which was directly dependent on the extent of the corrections required to be made in the AQR process.

3.2 Main results of the comprehensive assessment exercise

The ECB's comprehensive assessment exercise covered 130 banks, 15 of which are Spanish, from 18 euro area countries, plus Lithuania

The ECB's comprehensive assessment exercise covered 130 banks from 18 euro area countries, plus Lithuania. Of these, 15 are Spanish banks³ (accounting for somewhat more than 90% of the Spanish banking sector's total assets), which places Spain as the second country, along with Italy, with most banks subject to the exercise.

As described in the first section of this chapter, devoted to explaining the methodology of the exercise, the starting point was the level of CET1 at year-end 2013. On this basis, the exercise estimated the impact that its different components entail, considering three thresholds: 8% of CET1 for the AQR, 8% of CET1 for the baseline scenario of the stress test (ST), and 5.5% of CET1 for the adverse scenario.

³ The 15 Spanish participating banks were: Santander, BBVA, La Caixa, BFA/Bankia, Banco Popular, Sabadell, Kutxabank, Bankinter, Unicaja-CEISS, Abanca-NCG, Ibercaja, Catalunya Banc, BMN, Liberbank and Grupo Cajamar.

The net capital shortfall resulting from the comprehensive assessment process is approximately €9.5 billion; no Spanish bank has a net capital shortfall

Of the total of 130 European banks analysed, 25 showed a gross capital shortfall under one or more of the three thresholds considered (AQR, baseline ST or adverse ST). This shortfall entailed capital requirements of approximately €24.6 billion as at 31 December 2013. However, of these 25 banks with capital needs, 12 made capital increases during 2014 so only 13 of them showed a net capital shortfall. In short, the net capital shortfall resulting from the comprehensive assessment process is around €9.5 billion. Liberbank is the only Spanish bank on the list, with a capital shortfall of €32 million in the AQR that has already been covered by the capital measures taken by the bank in 2014 (for an amount of €637 million).

The impact of the AQR has been very limited for Spanish banks, consuming 14 bp of the capital ratio, compared with 42 pp for SSM banks on average

At the level of all the participating banks, in Spain's case the **impact of the AQR** has been very limited. Specifically, it has consumed only 14 bp of the capital ratio, compared with 42 bp for SSM banks on average. Indeed, Spain is the country evidencing the smallest capital correction in the AQR phase (see Chart 3.2.A). The net impact of the AQR was €33.8 billion for SSM banks as a whole, of which only €2.2 billion relate to Spanish banks. Following the 2012 comprehensive assessment exercise conducted in Spain (which contained an exhaustive asset quality review), and after both the extraordinary provisions set aside that year via Royal Decree-Laws 2/2012 and 18/2012, and the measures taken in 2013 regarding the review of forborne loans, Spanish banks' credit portfolios were revealed to be appropriately classified in terms of their credit quality (classification of loans as performing or non-performing), in relation to the value of the attendant collateral and to provisioning.

At the level of individual banks, the impact of the AQR, measured in bp of the CET1 ratio, varied from 105 bp to zero (see Chart 3.2.B). The capital ratio of virtually all the banks, after being subjected to the AQR, was clearly above the required 8% threshold, with the sole and above-mentioned exception of Liberbank, which at the end of the AQR was at 7.8%, entailing a capital shortfall of €32 million. As mentioned, this bank undertook various recapitalisation measures in 2014, which have already taken effect, for an amount of €637 million. Accordingly, the previous shortfall has been more than compensated, and no further recapitalisation measure is needed for this bank.

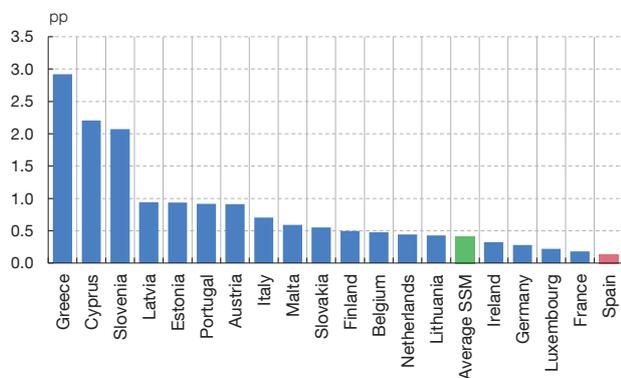
Under the baseline scenario, Spanish banks would show...

The **impact of the ST in the baseline scenario** on Spanish banks translates into an increase in their capital ratio of around 120 bp (see Chart 3.3.A), while for the SSM aggregate the

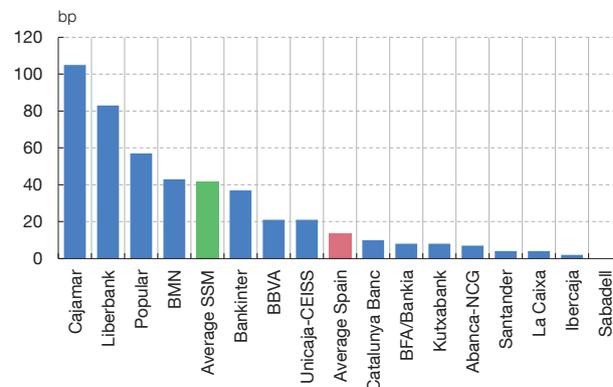
NET IMPACT ON CET1 RATIO OF THE AQR (a)

CHART 3.2

A. BY COUNTRY



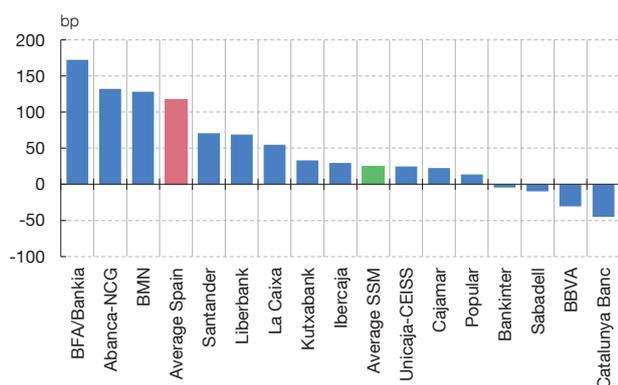
B. BY BANK



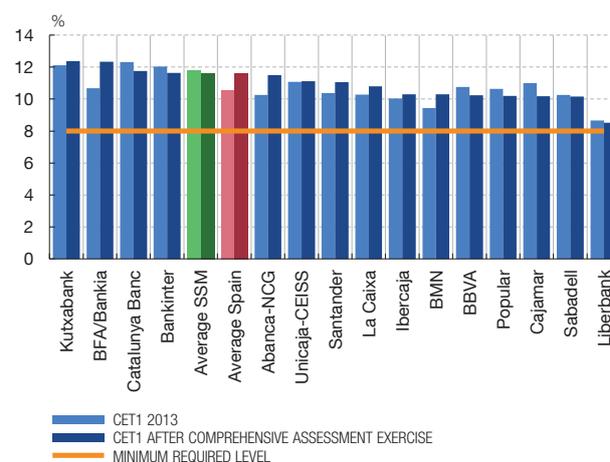
SOURCES: ECB and Banco de España.

a Net of tax effect.

A. INCREASE IN CET1 RATIO IN STRESS TEST, BY BANK



B. BANK-BY-BANK COMPARISON OF CET1 RATIO IN 2013 WITH CET1 RATIO AFTER COMPREHENSIVE ASSESSMENT EXERCISE



SOURCES: ECB and Banco de España.

... on aggregate an average capital ratio of 11.6% in 2016, meaning it would converge on the average for European banks

increase is approximately 30 bp. The impact on CET1 of the AQR and of the ST in the baseline scenario entailed, for Spanish banks as a whole, moving from an initial capital ratio in 2013 of 10.6% to a ratio of 11.6%. On average, the SSM banks started the exercise with a ratio of 11.7% and ended it slightly below that ratio, at around 11.6% (see Chart 3.3.B). Accordingly, despite their lower starting capital, at the end of the horizon the CET1 ratio of Spanish banks would converge on the SSM average, if the predictions envisaged in the baseline scenario were fulfilled.

At the individual bank level, the increase in the CET1 ratio discussed in connection with the aggregate level was the case for 11 Spanish banks, falling for the remaining four banks. In any event, all Spanish banks completed the comprehensive assessment exercise under the baseline scenario above the minimum required level of 8% (see Chart 3.3.B).

The impact of the ST under the adverse scenario subtracts 144 bp from the capital ratio for Spanish banks and more than 300 bp for SSM banks on average

The impact of the ST under the adverse scenario on Spanish banks' CET1 ratio was 144 bp. This impact did not give rise to a capital shortfall at any Spanish bank. The impact of the ST on SSM banks as a whole was sharper and entailed, on average, a reduction in the CET1 ratio of almost 300 bp. In absolute terms, the net capital decline in Spain was €17.2 billion, in comparison with almost €182 billion for the SSM overall. At country level, the impact on the capital ratio under the adverse scenario in Spain was one of the lowest, and was in fact only lower in Latvia and Estonia (see Chart 3.4.A).

At the level of the results for individual banks, and as observed in the analysis of the AQR results, some degree of heterogeneity was discernible (see Chart 3.4.B). Thus, whereas for the bank with the least impact the outcome was hardly over 20 bp of the CET1 ratio, at the bank with the biggest impact it was 420 bp (a reduction of over 4 pp in the ratio), although only for one Spanish bank is the impact greater than that for the aggregate of SSM banks, which is practically 300 bp.

In general, Spanish banks were 2 pp above the minimum required threshold following the comprehensive assessment exercise under the adverse scenario

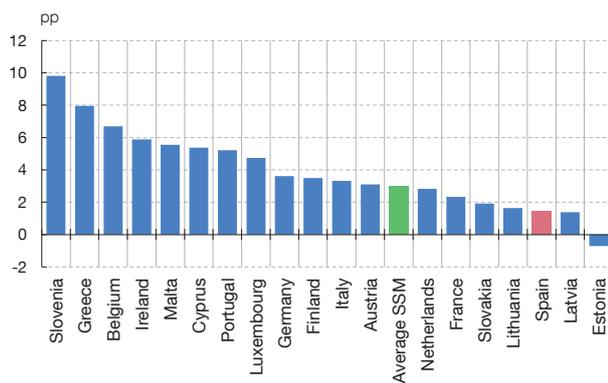
Finally, no Spanish bank, except Liberbank,⁴ has a final capital ratio in the adverse scenario below 7.5%, i.e. all the banks are 2 pp above the threshold set as the minimum solvency floor admissible in the comprehensive assessment exercise.

⁴ If the capital measures taken in 2014 were borne in mind, Liberbank would exceed the minimum required level in the adverse scenario by more than 2 pp.

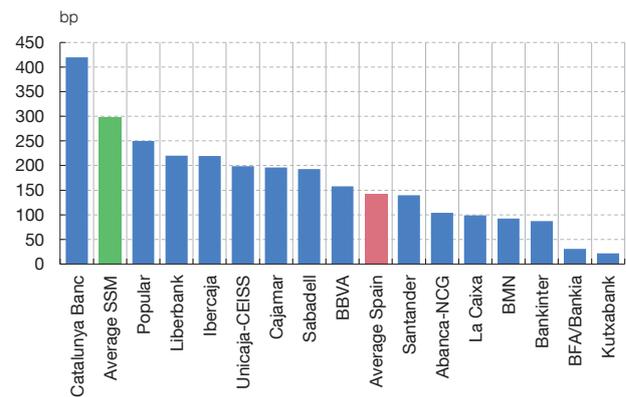
RESULTS OF THE COMPREHENSIVE ASSESSMENT EXERCISE IN THE ADVERSE SCENARIO

CHART 3.4

A. NET IMPACT ON CET1 RATIO OF STRESS TEST, BY COUNTRY (a)



B. REDUCTION IN CET1 RATIO IN STRESS TEST, BY BANK



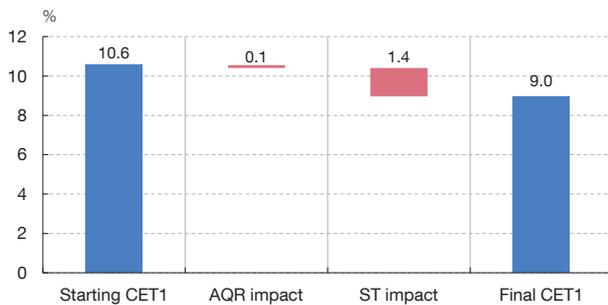
SOURCES: ECB and Banco de España.

a Net of tax effect.

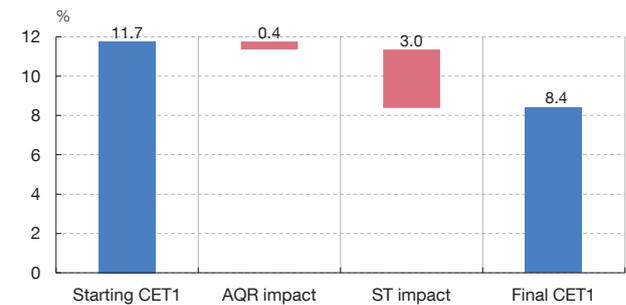
AGGREGATE RESULTS OF THE COMPREHENSIVE ASSESSMENT EXERCISE IN THE ADVERSE SCENARIO

CHART 3.5

A. IMPACT ON CET1 RATIO OF COMPREHENSIVE ASSESSMENT EXERCISE IN SPAIN



B. IMPACT ON CET1 RATIO OF COMPREHENSIVE ASSESSMENT EXERCISE. AVERAGE SSM



SOURCES: ECB and Banco de España.

The impact on capital of the adverse scenario would be far lower in Spain than the SSM average

In short, for the 15 Spanish banks, the starting CET1 ratio in 2013 stood at 10.6% of their risk-weighted assets (RWAs), while for all SSM banks it was 11.7%, just over 1 pp higher. Under the adverse scenario, and including the AQR effect, the CET1 ratio for Spanish banks as a whole stood at 9% (see Chart 3.5.A), i.e. 3.5 pp above the threshold set by the ECB for the comprehensive assessment exercise in the adverse scenario (5.5% of CET1). The aggregate of SSM banks concluded the comprehensive assessment exercise with a CET1 ratio of 8.4% (3 pp above the threshold, see Chart 3.5.B). This outcome entails a more marked relative impact for SSM banks than for their Spanish counterparts: a reduction in the CET1 ratio of 3.4 pp for the SSM aggregate, compared with a reduction of 1.6 pp for the aggregate of Spanish banks.

4 OTHER MATTERS

This chapter reports on the main advances made in various areas. The first section is devoted to a recent recommendation by the European Systemic Risk Board (ESRB) on the use in practice of the countercyclical capital buffer (CCB). The second section addresses the recent work by the Financial Stability Board (FSB) on shadow banking. The third section looks at the main proposals by international agencies relating to international accounting standards.

Box 4.1 compares the different models SSM countries are choosing for assigning resolution competences to one or more authorities. It reflects on the advantages and disadvantages of each of the models. As is analysed in detail in the Box, all SSM countries, with the exception of Finland, are opting to place the resolution authority under the same roof as the supervisory authority.

Finally, Box 4.2 describes different aspects of the Single Supervisory Mechanism (SSM). It also looks at the organisational structures with which the ECB and DG Supervision of the Banco de España have equipped themselves to address the needs arising as from 4 November this year with the effective entry into force of the SSM and the assumption of direct supervisory responsibilities by the ECB.

4.1 ESRB work on guidance for using the CCB

The CCB is one of the macroprudential instruments at a most advanced stage

The ESRB, on which the Member States' central banks and authorities overseeing banking, securities and insurance sit, along with representatives of various European authorities, is responsible for macroprudential supervision in the European Union. Much of the work of the ESRB in 2013 focused on the implementation of macroprudential instruments. The work took the form of various initiatives. Among these, the ESRB, in compliance with the provisions of the new European capital regulations, has issued a Recommendation on guidance for using the CCB, one of the macroprudential instruments whose implementation is at a most advanced stage.

The aim of the CCB is to ensure that the banking sector as a whole has sufficient capital to help maintain the flow of credit to the economy without the system's solvency being jeopardised in the event of tension in the financial system brought on by a prior period of excessive credit growth.

The use of the CCB follows the "guided discretion" principle. This means that the use of an initial, quantitative and standardised benchmark indicator (the credit-to-GDP¹ gap), which is selected for its capacity to act as a leading indicator of systemic banking crises, is complemented by other indicators, qualitative information and expert judgement, all of which structured by means of a set of principles.

In other words, to set the level of the CCB, the starting point is a "mechanical" benchmark indicator (the credit-to-GDP gap), with a rule in place, moreover, to connect different levels of this indicator with the benchmark buffer rate to be applied². However, the Basel Committee on Banking Supervision's credit-to-GDP gap does not work the same in all settings and all countries alike. Therefore, in setting the CCB level, other possible specifications of the credit-to-GDP gap, other quantitative indicators and other qualitative factors should also be considered.

¹ The credit-to-GDP gap is calculated as the deviation by the credit-to-GDP ratio from its long-term trend.

² Under this rule, the level of the CCB is 0% when the credit-to-GDP gap is below 2%, and thereafter the CCB rate increases linearly up to its maximum level of 2.5% when the credit-to-GDP gap reaches a value of 10%.

The Resolution Directive (BRRD), which is currently being transposed into the legislation of most of the Member States, stipulates the formal designation of a national resolution authority by 31 December 2014. The resolution powers arising from the Single Resolution Mechanism shall then be attributed to this authority.

The term “resolution” is understood to encompass the processes aimed at ensuring the continuity of the essential functions of banks deemed to be inviable at a given time, to preserve financial stability and to restore the viability of the bank in full or in part. There are two types of resolution measures: preventive action, involving ex-ante planning for all banks of the arrangements for their potential resolution should that become necessary; and the actual management of resolution, or resolution in the strict sense of the term.

Given the undoubted relatedness of this function to the tasks performed by banking supervisors, the Directive expressly acknowledges that the national prudential supervision authority may be designated as the national resolution authority, although organisational measures must be adopted to ensure operational independence and to avoid conflicts of interest between supervisory and resolution functions.

The most significant alternative model would involve the creation of a resolution agency separate from the prudential supervisor, with the possibility of distributing specific competences among more than one agency also been envisaged.

Each of the possible models has advantages and disadvantages.

The advantages of a model in which the resolution authority is part of the supervisory authority have to do with arguments of efficiency and institutional economics. In particular, this model lessens potential problems of coordination between supervisory or resolution-related measures that reduce their effectiveness in terms of preserving financial stability. It also offers greater flexibility by allowing immediate flows of resources from one function to another in view of particular needs at each point in time, and it minimises the risk of supervisory work being duplicated, especially in work relating to the preventive phase of resolution (i.e. before an institution is ruled to be non-viable). Finally, when the prudential supervisor is the central bank, the assumption by the latter of the

resolution function would enable this task to benefit from the consequences arising from the EU Treaty-stipulated independent status of central banks.

The disadvantage of this model is that internal mechanisms are needed, if both functions are located in a single institution, to avoid conflicts of interest between those catered for by supervisory functions and the interests proper to resolution functions.

The main advantage of an institutional arrangement under which the resolution authority is separate from the supervisory authority is that this directly prevents the potential emergence of the conflicts of interest referred to in the foregoing paragraph. Conversely, as a disadvantage, it involves creating risks of inefficiency, duplication and inconsistency with supervisory conduct.

Among the various alternatives offered by the Directive, the Member States have opted primarily for integrating the resolution authority into the banking authority, albeit establishing a governance regime that ensures sufficient segregation between resolution and supervision tasks (the “agency within an agency” model).

Using colour codes, Table A shows the distribution of resolution functions derived from the BRRD being undertaken in those SSM (euro area) countries on which information is available. For greater clarity, there is a separation, within the resolution framework, between the ongoing “prevention phase”, in which competences are closely linked to the current functions of the prudential supervisor, and the resolution phase in the strict sense of the term.

As can be seen, all the SSM countries, with the sole exception of Finland, are opting to integrate the resolution authority into the supervisory authority (see Table A).

Among the EU countries, only Finland and Denmark envisage designating a resolution authority that is independent from the banking supervisor. In another two cases (Poland and Sweden) it is planned to distribute functions between the supervisory authority (preventive phase and/or activation of the resolution trigger) and another specifically designated authority with resolution functions.

A ALLOCATION OF RESOLUTION COMPETENCES ARISING FROM THE BRRD IN THE SSM MEMBER COUNTRIES (a)

Member State	Preventive phase		Resolution phase		Management of Resolution Fund
	Resolvability and resolution plans	Determination of MREL (b)	Activation of resolution trigger	Implementation of resolution instruments	
Belgium	Nationale Bank van België/ Banque Nationale de Belgique	Nationale Bank van België/ Banque Nationale de Belgique	Nationale Bank van België/ Banque Nationale de Belgique	Nationale Bank van België/ Banque Nationale de Belgique	Nationale Bank van België/ Banque Nationale de Belgique – Resolution Fund
Cyprus	Central Bank of Cyprus	Central Bank of Cyprus	Central Bank of Cyprus	Central Bank of Cyprus	Central Bank of Cyprus
Finland	Financial Crisis Resolution Bureau	Financial Crisis Resolution Bureau- Deposit Guarantee and Resolution Fund			
France	Prudential Control and Resolution Authority	Prudential Control and Resolution Authority - Deposit Guarantee and Resolution Fund			
Germany (c)	BaFin	BaFin	BaFin	BaFin	BaFin
Greece	Bank of Greece	Bank of Greece	Bank of Greece	Bank of Greece	Bank of Greece - Greek Deposit Guarantee and Investment Fund
Ireland	Central Bank of Ireland	Central Bank of Ireland	Central Bank of Ireland	Central Bank of Ireland	Central Bank of Ireland
Italy (d)	Banca d'Italia	Banca d'Italia	Banca d'Italia	Banca d'Italia	Pending
Latvia	Financial and Capital Market Commission	Pending			
Malta	Malta Financial Services Authority				
Netherlands	De Nederlandsche Bank	De Nederlandsche Bank	De Nederlandsche Bank	De Nederlandsche Bank	Pending
Portugal	Banco de Portugal	Banco de Portugal	Banco de Portugal	Banco de Portugal	Banco de Portugal - Resolution Fund
Slovenia	Banka Slovenije				

SOURCE: Banco de España.

a  National resolution authority part of the prudential supervisory authority.

b  National resolution authority independent from prudential supervisor.

b MREL: minimum requirement of own funds and eligible liabilities

c For a transitional period, an authority other than the supervisory authority FMSA is designated as the resolution authority. However, the draft Law itself clarifies that this authority shall be integrated into BaFin following the "agency within an agency" model.

d In the final regulatory text, some role to be played by the Ministry of Economy in activating the resolution trigger might be acknowledged.

The ESRB, in compliance with the requirements of the European solvency regulations, issued a Recommendation in June this year on guidance for setting CCB rates

The ESRB, in compliance with the requirements of the European solvency regulations, issued a Recommendation in June this year offering guidance on the setting of CCB rates in the EU (ESRB/2014/1³). This Recommendation implements and adapts the Basel principles to the European Union and establishes two additional principles: one on communication, and the other on mutual recognition by countries of the buffer rate. Set out below are elements for measuring and calculating the credit-to-GDP gap and calculating the CCB rate to be applied. The Recommendation also offers guidance on which other quantitative indicators can help signal both the activation and deactivation of the CCB.

As regards compliance periods, the designated national authorities and the ECB are expected, by June 2016 at the latest, to send a report to the ESRB, the European Council and the European Commission explaining the measures taken to comply with the recommendation. If the authorities decide to activate the CCB beforehand, the recommendations will be applicable as from the time the CCB is activated. Finally, the national authorities shall send reports every three years explaining the implementation of the measures contained in the recommendation.

4.2 Shadow banking

Most of the macroprudential instruments considered so far address risks in the banking sector. However, so-called shadow banking operations are also of relevance to the goal of preventing and mitigating financial stability-related risks.

The FSB broadly defines the shadow banking sector as credit intermediation involving activities or institutions outside the regular banking sector. Under this definition, the shadow banking segment requiring most attention owing to its potential effects on financial stability is that whose credit intermediation activities may generate systemic risks and or regulatory arbitrage. As to systemic risks, particular attention should be paid to those activities involving liquidity and maturity transformation, leverage and imperfect credit risk transfer. A simplified way of conceptually bounding the scope of shadow banking is to confine it to financial activities with bank-like characteristics (entailing leverage and maturity transformation) performed by non-bank financial institutions. This is what the FSB calls a narrow definition of the shadow banking system.

The FSB has set in train initiatives for the monitoring of the shadow banking system and has proposed measures for different areas

To address the risks arising from the shadow banking system, the FSB is working along two lines. First, to set in place a monitoring framework that enables the national authorities to analyse developments in shadow banking with the aim of identifying the build-up of systemic risks in this area, and ultimately, to take corrective measures. Second, to strengthen oversight and regulation of different areas of the shadow banking system.⁴ Here, and at the European level, there are currently two proposed European Commission Regulations. First, that on Money Market Funds, of September 2013; and second, that on securities financing transactions, in January this year.

In order to monitor the shadow banking system, the FSB's work takes the form of three steps. The first involves analysing the financial system as a whole in an attempt to approximate the weight of the shadow banking system. In this step the broad definition of the shadow banking system is adopted, whereby it is defined as the set of the so-called "other financial institutions"⁵(OFIs), and the information is obtained from each country's

3 European Systemic Risk Board (2014) "Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates", ESRB/2014/1.

4 See, for example, FSB (2013) "Strengthening oversight and regulation of shadow banking – An overview of policy recommendations", August.

5 OFIs are financial institutions that are not banks, insurance companies or pension funds.

Over the last few months the work has been completed for the creation of a Single Supervisory Mechanism (SSM).

The main aim of the SSM is to enhance the quality of banking sector supervision in the participating countries¹ and promote greater financial integration, so as to prevent the markets from assigning different valuations to similar financial assets on the basis of the nationality of the issuer. This is essential to break the negative link between doubts about the solvency of credit institutions and sovereign risk which, in the most acute stages of the recent crisis, triggered doubts over the very continuity of monetary union.

The new supervisory mechanism will become fully operational on 4 November 2014. In order to make this possible, following the approval of the SSM Regulation in October 2013 and in tandem with a Comprehensive Assessment exercise covering the significant euro area banks (see Chapter 3 of this Report), much work has been done to define the legal framework, organisation and supervisory model of the SSM. A Framework Regulation has been approved, establishing the main outlines of the supervisory function and its organisation, and clarifying the division of responsibilities between the ECB and the national authorities. A Supervisory Manual has also been prepared, establishing the procedures to be followed in the performance of supervisory tasks, which will help to harmonise the procedures within the SSM².

The SSM is an integrated system of oversight of credit institutions, combining the leadership of the ECB with the active participation of the national authorities, including the Banco de España. In this respect, both the ECB and the national authorities will be bound to cooperate in good faith and to exchange information in the exercise of their respective powers.

When defining the governance arrangements of the SSM, particular note was taken of the need to ensure that the new supervisory tasks assumed by the ECB do not clash with its powers in the area of monetary policy. To that end, in accordance with the SSM Regulation, a Supervisory Board has been established within the ECB to plan and carry out supervisory tasks. The Supervisory Board is composed of a chair and vice-chair, a representative of each national authority and four representatives of the ECB. They will propose draft decisions to the Governing Council of the ECB, which is the final decision-making body. Nevertheless, supervisory decisions will be adopted by the “non-objection” procedure, whereby the Governing Council may not amend the proposals, but it may return them to the Supervisory Board for reconsideration. The Regulation provides for the creation of a Mediation Panel, entrusted with settling any potential disagreements between the two bodies.

An Administrative Board of Review has also been established, with the power to conduct an internal administrative review of the decisions made by the ECB in the exercise of its supervisory powers. Any natural person or supervised entity may ask for a decision to be reviewed, provided that the decision directly affects

that person or entity. The Board of Review has five independent members.

The list of banks to be directly supervised by the ECB was finalised in September. In view of the large number of credit institutions established in the euro area, the SSM Regulation distinguishes between “significant” banks, which are to be directly supervised by the ECB, and “less significant” banks which will continue to be the responsibility of the national authorities, even though the ECB will supervise them indirectly.

The criteria used to determine the significance of a bank are as follows:

- It has total consolidated assets over €30 billion.
- The ratio of assets to the GDP of the country where it is established exceeds 20%, unless its total consolidated assets are below €5 billion.
- It is one of the three largest banks in a Member State.
- It has subsidiaries, in more than one of the participating countries, whose cross-border assets or liabilities account for more than 20% of its total assets or liabilities.
- It has received or requested direct financial assistance from the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM).

On this basis, a list of 120 significant banks has been drawn up, representing approximately 85% of euro area bank assets. Fifteen of these are Spanish (a number that will drop to 14 when a concentration process currently under way concludes). A list of some 3,700 less significant institutions throughout the euro area has also been drawn up. In the case of Spain, the significant banks that will be supervised directly by the ECB account for more than 90% of the assets of the country’s deposit-taking institutions.

In order to be able to perform its new tasks, the ECB has established a new organisational structure specifically for supervision, creating four new directorates general; two will be responsible for day-to-day supervision of the significant banks; a third for indirect supervision of the less significant banks, aiming to ensure that supervisory practices are harmonised and meet maximum quality standards; and a fourth for specialised and horizontal tasks relating to all the banks supervised by the SSM. Moreover, the ECB personnel selection processes for exercise of the new supervisory powers are at a very advanced stage and a good number of Banco de España staff have been selected here,

¹ All the euro area countries take part in the SSM, but any EU country that decides to enter into a close cooperation agreement with the ECB may also join, in accordance with the terms laid down in the Regulation.

² See <http://www.ecb.europa.eu/pub/pdf/other/ssmguidebankingsupervision201409en.pdf?85e39f5cf761e11147f6e828cd4088b13>.

both among senior management (one of the four directors general and two of the seven deputy directors general are from the Banco de España) and middle management and supervisory staff in general.

The entry into operation of the SSM will entail a far-reaching change in the supervisory responsibilities of the national authorities. To smooth this process, the Banco de España has recently approved a reorganisation of its Directorate General Banking Supervision, with a view to ensuring that it can participate in the new mechanism as efficiently as possible. For that purpose the four existing departments have been reorganised so as to mirror, insofar as possible, the structure and tasks of the ECB's four directorates general.

In addition, a Joint Supervisory Team (JST) has been created for each significant bank. These teams are made up of staff from both the ECB and the national authorities, and will each be headed by an ECB coordinator who will be assisted, in turn, by one or more deputy coordinators from the national authorities. The teams will be responsible, inter alia, for the ongoing assessment of the risk profile, capital adequacy and liquidity of the banks. They will also be tasked with preparing draft decisions to be submitted to the Supervisory Board.

As regards the significant banks, the Banco de España, as a competent national authority, shall assist the ECB, providing its experience and the majority of supervisors on the JSTs (in a proportion of approximately 4 to 1). Among other tasks, the Banco

de España shall also provide support for on-site inspections, compile and convey any information required, take part in the preparation of supervisory decisions and collaborate in penalty procedures.

One key difference from the existing supervisory model in Spain is that the new SSM model draws a clear distinction between monitoring and inspection activities, which will be performed by different teams. In this respect, it is envisaged that the on-site inspection teams will be essentially national teams, although the ECB will ensure that all countries follow the same quality criteria and methods. For the purposes of this work, as part of the recent reorganisation at the Banco de España, several specialised inspection teams have been created.

Lastly, the national authorities will be responsible for directly supervising the less significant banks (except for matters relating to common procedures: processes for authorisation and withdrawal of authorisation, and decisions relating to qualifying holdings). In any event, in the exercise of these powers the national authorities shall keep the ECB informed at all times. The ECB will monitor the quality of the supervision work and, as the ultimate party responsible for the smooth functioning of the SSM, may issue regulations, guidelines or general instructions designed to ensure that supervisory practices are consistent. Moreover, where necessary and after consulting with the relevant national authority, the ECB may decide to take on the direct supervision of a less significant bank if it is necessary in order to ensure that supervisory rules are uniformly applied.

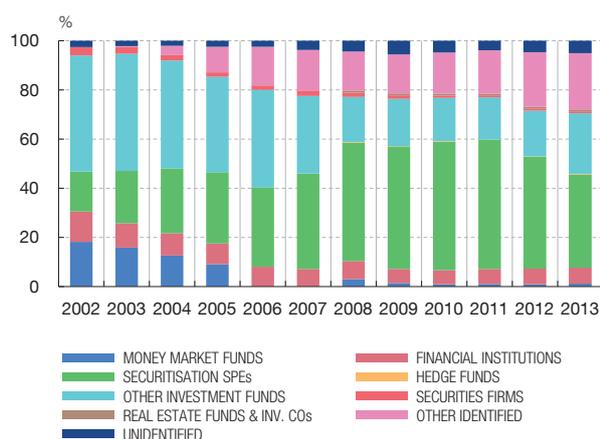
Financial Accounts, supplementing them with other relevant sources (information from supervisors). The second step consists of identifying those aspects of the shadow banking system that generate systemic risks, or that may give rise to regulatory arbitrage situations. In this case, the focus will be on those credit intermediation activities that involve liquidity and maturity transformation, leverage and imperfect credit risk transfer and which, in turn, through banking consolidation, are not already covered by banking regulation and supervision. Finally, in the third step, it is sought to deepen the assessment and analysis of the systemic risks and possibilities of regulatory arbitrage identified, having regard to the interconnections between the shadow banking system and the traditional banking system.

The weight of shadow banking in Spain is comparatively low

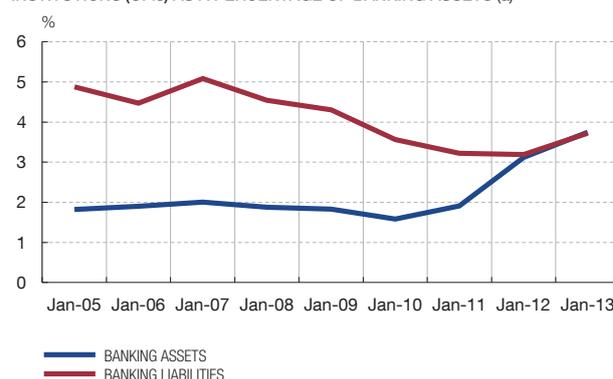
As part of its monitoring work, the FSB has since 2011 been conducting a global monitoring exercise aimed at assessing trends and risks in the shadow banking system.⁶ Following the line of this monitoring exercise, the relative weight of shadow banking in Spain can be seen to be comparatively low. The most significant institutions among OFIs were investment funds until 2006, at which time they were displaced by securitisation special-purpose entities, although in 2013 investment funds did begin to regain part of their share, as is highlighted in Chapter 2 (see Chart 4.1.A).

⁶ See FSB (2013) "Global Shadow Banking Monitoring Report 2013", November.

A. STRUCTURE OF OTHER FINANCIAL INSTITUTIONS (OFIs) IN SPAIN



B. BANKING ASSETS AND LIABILITIES VIS-À-VIS OTHER FINANCIAL INSTITUTIONS (OFIs) AS A PERCENTAGE OF BANKING ASSETS (a)



SOURCE: Banco de España.

a OFIs which consolidate with banking institutions and/or which do not intermediate in credit are excluded.

In Spain, more than 40% of OFIs' assets in 2013 related to institutions consolidating into banking groups, mainly owing to securitisation special-purpose entities. If entities not engaging in credit intermediation — such as equity funds and listed real estate investment companies (SOCIMIS by their Spanish acronym) — are added here, it is seen that the assets of shadow banks account for 46% of GDP, this ratio being one of the lowest among the developed countries (see footnote 6). Of these assets, almost half are assets of other investment funds, i.e. those other than equity funds.

Chart 4.1.B shows the weight of bank assets and liabilities vis-à-vis shadow banking system entities in Spain following the FSB's "narrow" definition. These bank assets vis-à-vis shadow banking entities institutions were until 2011 always below 2% of the banking balance sheet and, in 2013, stood at 3.7%. The growth observed in 2013 can chiefly be explained by the decline in banking assets. Likewise, Spanish banks' dependence on these entities for their funding is low, since bank liabilities, too, vis-à-vis shadow banks accounted for only 3.7% of their balance sheet in 2013. As with assets, the growth seen in 2013 is attributable in the main to the decline in banking assets.

4.3 Publication of IFRS 9

Since 2002, the two main issuers of accounting standards worldwide — the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) — have been working together to reduce the differences between their respective accounting models. The crisis revealed significant weaknesses in the accounting treatment of financial instruments (technical complexity and scant and slow recognition of impairment) and in consequence, in April 2009, the G-20 asked both bodies to review and align their respective standards. As a result the work was expedited, with a view to reducing the complexity and issuing a new common standard.

IFRS 9 is the IASB's response to the G-20's request to overcome the weaknesses of the accounting framework that the crisis revealed

On 24 July 2014 International Financial Reporting Standard (IFRS) 9 was published, replacing International Accounting Standard (IAS) 39, and which is the IASB's response to the G-20's concerns. IFRS 9, which will apply from 1 January 2018, contains new features that are of particular significance with regard to how credit losses are estimated and recognised and how financial assets are classified and measured, and to hedge accounting.

Most importantly for the banking sector, IFRS 9 changes how credit losses are estimated and recognised

Under IAS 39, recognition of impairment of financial assets not recorded on the balance sheet at fair value was subject to the existence of an observable loss event; this is what is known as an incurred loss model. The financial crisis revealed the weaknesses of this model, as credit loss recognition was too little, too late.

In response to this problem IFRS 9 introduces a new approach, that is, the expected loss model, based on the following recognition methodology:

- When the transaction is initially reported, credit losses associated with the default events estimated over a 12-month horizon are recognised.
- Subsequently, lifetime expected credit losses (i.e. those arising from the default events estimated beyond the 12-month horizon) will be recognised when there is a significant increase in the credit risk associated with the exposure in comparison with the credit risk assigned when it was first reported on the balance sheet.

IFRS 9 does not establish a specific methodology to determine when this significant increase in credit risk arises although, to simplify the analysis, it does establish a rebuttable presumption of more than 30 days past due. It also admits collective analysis for groups of assets with uniform credit risk.

IFRS 9 leaves the default criterion to be used in banks' hands, without offering a specific methodology for estimating expected losses. It simply recommends that historical loss rates be used as a starting point, adjusted for current and forecast credit conditions on the estimation date, in each disclosure of financial statements.

IFRS 9 also changes the criteria for classifying and measuring financial assets,...

IFRS 9 also makes changes to how financial assets are classified and measured. In this case, measurement bases such as amortised cost and fair value are still used, but financial assets are reclassified between measurement categories.

Under IAS 39, whether an instrument was classified in one portfolio or another depended on management's intentions. For example, a financial asset held to produce gains in the short term was classified in the trading book, while the same instrument acquired with the intention of holding it to maturity was classified in the held-to-maturity portfolio. In the first case, the asset was recorded on the balance sheet at fair value, while in the second it was recorded at amortised cost.

IFRS 9 replaces this form of classifying financial assets by portfolios with two different criteria: the cash flow characteristics of the asset and the business model of the entity.⁷ The overall result of this change is that financial assets that resemble debt instruments will only be measured at amortised cost if the business model implies that they are held essentially to collect the contractual cash flows. Without entering into the more technical details of the standard, financial assets resembling debt that are not held only to collect the contractual cash flows are recorded at fair value, with any changes in their value being directly recorded through equity, while all other financial instruments will also be recorded at fair value, but with any changes in their value being recorded through the income statement.

⁷ The business model is understood as the way in which the entity manages assets in order to generate cash flows.

... and for hedge accounting

Lastly, the third change made by IFRS 9 relates to hedge accounting, where a new general framework is established which eases the requirements for applying hedge accounting and the measurement of hedge effectiveness, but which will essentially affect companies that use hedges with non-financial underlyings.

For its part, even though the US regulator (FASB) has not yet published its standard, and is not expected to do so until well into 2015, that standard will be different from IFRS 9 and will, to the best of our knowledge, entail, among other differences, initial recognition of total expected losses, which will mean earlier recognition and reporting of impairment of financial assets than under IFRS 9 and will signify, despite the insistence of the G-20, failure to achieve the desired convergence between the IASB and FASB standards.

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- 2 Moreover, it is updated daily in the Statistics section.
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