

**FINANCIAL STABILITY
REPORT**

11/2015

BANCO DE ESPAÑA
Eurosistema



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ABBREVIATIONS (*)

€	Euro
AIAF	Asociación de Intermediarios de Activos Financieros (Association of Securities Dealers)
ABCP	Asset-backed commercial paper
ATA	Average total assets
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BLS	Bank Lending Survey
bn	Billions
bp	Basis points
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

1 Key developments

International financial markets face an environment of monetary policy divergences and greater uncertainty over global growth, with a progressive increase in volatility. The scenario for the world economy is marked by a moderate pick-up in activity in the advanced regions and by the prolongation of the slowdown in the emerging economies. The defining features of the international setting in which Spanish deposit institutions are pursuing their activity are as follows: doubts concerning the Chinese economy, which affected stock markets in the form of increased volatility and heavy declines in share prices; uncertainty over the possible start of interest rate rises in the United States; the fall in commodities prices; and the low levels of inflation and nominal growth in the advanced economies and, in particular, in the euro area, entailing very low interest rates.

In this setting, the year-on-year rate of credit to the resident private sector in Spain fell by 4.5% in June 2015, meaning its rate of decline has continued to ease. The lower decline is due essentially to credit to non-financial corporations, which posted a lesser fall, in terms both of credit extended to property development and construction activities and to the other sectors. Non-performing loans continued to decline, and since early 2014 they have uninterruptedly posted negative month-on-month changes. The declining trend is extensive to households and non-financial corporations. The substantial fall in non-performing loans translates into an improvement in the NPL ratio, which stood at 11.2% in August 2015. This reduction in NPLs is across the board and across every type of purpose of lending.

Spanish deposit institutions' total consolidated income increased in the first half of 2015 compared with the previous year, with their ROE standing at 9.2%. The improvement was due both to an increase in net interest income and to a decline in asset impairment provisions. However, most of the improvement is mainly due to foreign business, since the return on domestic activity has been subject to various pressures: low interest rates in the euro area; the still-diminished dynamism of banking activity; and the still-high volumes of NPL. These factors explain why the profitability of domestic business remains far below the historical average, though it remains in line with that of our peer countries.

With regard to banks' solvency, their maximum-quality common equity Tier 1 (CET1) capital ratio has increased over the past year and stands in June at 12.4%, almost 1 pp up on twelve months earlier.

Accordingly, the Spanish banking sector has continued to increase its resilience to various shocks. That said, following the usual practice in other financial stability reports, this FSR focuses on the potential economic and financial developments that might adversely impact the stability of the Spanish banking system.

2 Factors of risk

Specifically, this FSR identifies three main factors of risk (see Table 1). The first directly affects Spanish deposit institutions' income statement. The other two may more indirectly impact Spanish banks' financial position. In the current circumstances, the first risk is one of medium intensity (orange) while the other two are low-intensity risks (yellow). These risks are shared, to differing degrees of intensity, by other banking systems in the developed world and, in particular, by those belonging to the Single Supervisory Mechanism (SSM).

1	Low profitability in the banking business in Spain, against a very low interest rate background, which may last in time, together with a still limited dinamism of the banking activity and with a high volume of NPLs, though declining.
2	Increase in the decelerating speed of emerging economies, especially where Spanish banks have partially their foreign exposure.
3	Financial assets' price correction, along with increases in the risk premium, both public and private.

SOURCE: Banco de España.

a Colour ranking within the chart must be understood as follows: green colour shows a no-risk situation, yellow shows low risk, orange shows medium risk and red shows high risk. The temporal horizon for which previous risks are defined is established by the FSR frequency, i.e., it is biannual.

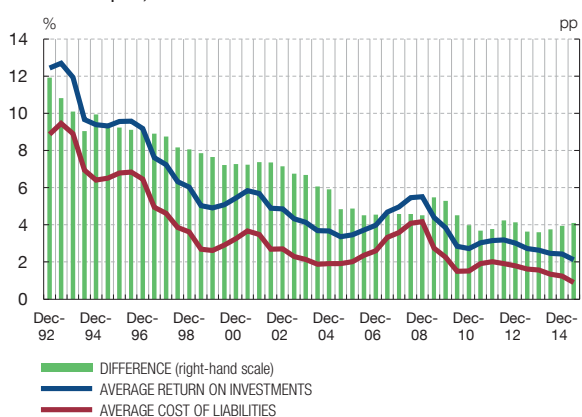
2.1 LOW PROFITABILITY OF BANKING BUSINESS IN SPAIN.

The low interest rate environment, in response to a euro area inflation rate lower than the ECB objective, is exerting significant pressure on Spanish deposit institutions' net interest income in their business in Spain. This is evident in Chart A, where the interest rate spread (difference between lending and deposit rates) is at historically very low levels of close to 1%. Even though in recent quarters there has been some visible improvement in this margin, the sustainability over time of net interest income in situations like the present, where the rate spread is so small, depends largely on there being a sufficiently high level of business that enables the scant contribution of the income statement produced via prices to be offset via amounts. That is not yet the case, as the total volume of lending and of bank deposits – the two biggest balance sheet items – continues to be seen to be declining.

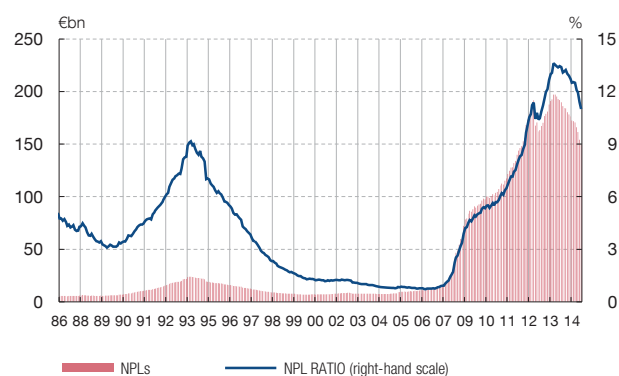
One factor adding further downward pressure on the profitability of banking business in Spain is the high relative volume of NPLs and foreclosed assets on institutions' balance sheets. Chart B shows that both the NPL ratio and the absolute volume of NPLs in the form of lending to the resident private sector peaked in late 2013, having since initiated a declining trend.

The risk to profitability is mitigated by the ongoing decline since 2013 in the volume of credit risk provisions set aside by banks, in line with the turnaround in NPLs further to the pick-up in economic activity in Spain. Moreover, the containment of costs helps counter the pressure bearing down on income statements in Spain.

A DIFFERENCE BETWEEN AVERAGE RETURN ON INVESTMENT AND AVERAGE COST OF LIABILITIES Business in Spain, ID



B RESIDENT PRIVATE SECTOR NPLs AND NPL RATIO Business in Spain, ID



SOURCE: Banco de España.

The Spanish banking sector has moved forward from the very high losses it posted in 2012 and has once again recorded positive and growing levels of ROE for business in Spain (around 5% in June 2015). That said, keeping ROE levels over time below the cost of capital poses a challenge to Spanish institutions, as it does for the European banking system as a whole. Under these conditions, banks will have to adjust their business model and, where necessary, their corporate strategy so as to adapt their organisation and structure to a highly demanding economic and regulatory environment.

2.2 STEP-UP IN THE PACE OF THE SLOWDOWN IN THE EMERGING ECONOMIES.

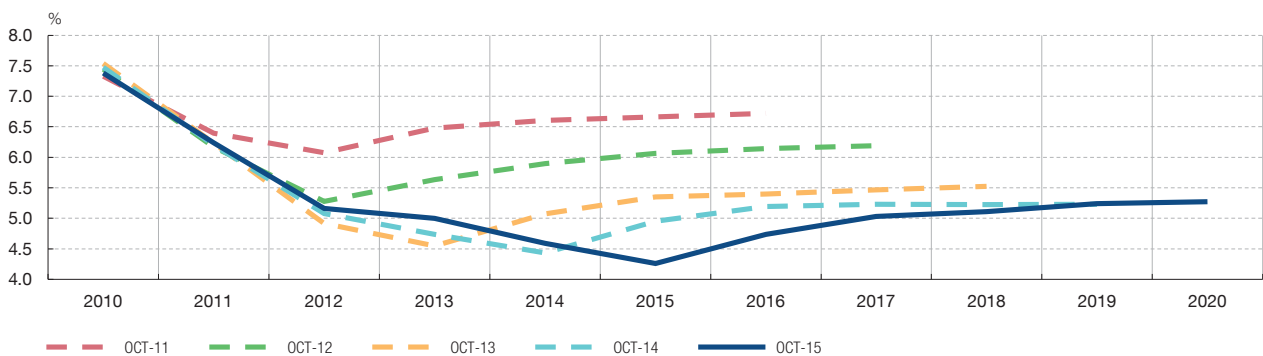
In recent years the emerging economies have undergone a gradual slowdown which, albeit at differing intensities in different regions, has been fairly widespread (see Chart C). This has been due not only to conjunctural factors but also to various trends, chiefly the lower growth of productivity and less favourable demographics, which are, at least in part, structural in nature. Given its growing weight in the global economy, the slowdown in China's economy, immersed in a transition towards a new pattern of growth which, foreseeably, will lead to lower but more sustainable growth rates over time, has proven particularly significant. The recent turbulence originating on Chinese stock markets highlights the fact that this rebalancing process is not free from risks and may, at least temporarily, entail lower-than-anticipated rates of increase in activity.

Moreover, the emerging economies will foreseeably be affected, possibly for a prolonged period, by continuing low commodities prices (in the case of producers) and, in the shorter term, by the possible tightening of global financial conditions, which will accentuate the complexity of the adjustment for those economies which had seen a strong expansion in credit and investment during the cyclical upturn. Further, there are idiosyncratic elements in some of the main emerging economies (such as Brazil and Turkey) pointing in the same direction. Latin America is particularly sensitive to these developments given its trade ties with China, the significance of its commodities exports and its dependence on external financing.

Generally, the possible step-up in the slowdown of the emerging economies poses a significant risk for the global economy, especially if this disturbance is accompanied by corrections in financial asset prices. The potential effects on the Spanish economy would come about both through the trade channel and investor confidence, and also through the exposure of Spanish financial and non-financial corporations to the economies most affected.

That said, the impact of the weakening of the emerging economies has not so far had a significant impact on the results of Spanish banks present in these economies.

C 2011-2015 IMF GDP GROWTH FORECASTS FOR THE EMERGING COUNTRIES
Year-on-year rates of change



SOURCE: International Monetary Fund.

The future path of prices negotiated on national and international financial markets is subject to certain risks arising from corrections linked to differing shocks. At the international level, two scenarios that might trigger a potential correction in valuations may currently be identified. Firstly, a more-unfavourable-than-expected outlook for global growth and greater uncertainty over this outlook might raise agents' risk-aversion, which would translate into an increase in both credit and markets risk premia. The likelihood of this scenario materialising has recently increased, as highlighted by the rise in volatility on international stock markets against the background of doubts over the scope of the slowdown in the emerging economies. Secondly, a change in the course of the US monetary policy normalisation strategy, insofar as such policy is not sufficiently anticipated by the markets, might trigger a rise in volatility and an increase in the term premia implicit in long-term debt yields (see Charts D and E). In principle, however, a less adverse effect of this shock might be expected for financial stability in comparison with the previous scenario if the changes are not accompanied by a worsening of the global growth outlook.

Alternatively, the correction of prices on financial markets might originate in a possible re-emergence of tensions within the euro area, although progress in the institutional design of the euro area in recent years has increased the range of instruments available to face scenarios involving tensions on financial markets and has reduced the potential scope thereof, as illustrated by the experience with the Greek crisis last summer. Furthermore, following the agreements reached in July between Greece and its creditors, the risk of financial tensions in the euro area has abated.

Lastly, the correction of valuations on financial markets might also be domestic in origin and be associated with a loss of investor confidence in the Spanish economy's ability to see through outstanding adjustments as a consequence, for example, of the perception of reform fatigue or of insufficient headway in restoring the main macro-financial and fiscal equilibria.

The potential materialisation of any of these scenarios might have significant repercussions for the Spanish economy and for financial stability. First, a sharp correction in the valuations prevailing on the markets might give rise to losses in the banking books of credit institutions and other intermediaries, but it might above all translate into a tightening of financing conditions, in a setting in which the improvement in these conditions has been contributing significantly to the economic recovery under way and in which the public and private sectors continue to hold high aggregate debt levels and evidence,

D TERM PREMIUM AND INTEREST RATES. USA



E BANK BOND SPREADS (a)
AVERAGE A-AAA



SOURCES: Datastream and New York Federal Reserve.

a Spread calculated using Treasury zero-coupon curve (USA) and asset swaps (euro area and UK).

therefore, sizable refinancing needs. To minimise the scope of these risks, and reduce their likelihood of occurring in the case of those that are domestic in origin, it is vital to continue striving to improve the structural functioning of the Spanish economy and to ensure compliance as scheduled with the fiscal consolidation path.

The three aforementioned risks are set out in greater detail in the course of this Report. In any event, given the satisfactory position of solvency generally maintained by Spanish banks following the increase in their capital ratios in recent years, the sector is suitably positioned to meet the challenges indicated and the risks described are thus not expected to have an immediate and significant influence on Spanish banks' situation.

3 Other matters

Chapter 3 sets out the treatment of deferred tax assets under current tax and banking solvency regulations. It further describes the legislative changes recently introduced with a view to dispelling any possible uncertainty over the compatibility of Spanish rules and the European legal framework in respect of State aid.

1 MACROECONOMIC RISKS AND FINANCIAL MARKETS

1.1 External environment of the euro area

International financial markets reflected heightening uncertainty...

Since the publication of the last Financial Stability Report in May, international financial markets have reflected a scenario of greater uncertainty, linked initially to the negotiations between Greece and its creditors, and subsequently to developments on the emerging markets. This latter factor of risk heightened in August, following the growing doubts about the Chinese economy, which prompted increases in volatility and heavy falls in equity market prices. A higher level of volatility than in the past continued to be seen on non-stock markets, but without rises on the scale recorded on stock markets. Against this background, financial markets appear to be adapting to an environment in which divergences in the monetary policy stance of some of the main central banks are expected to widen and in which doubts over global growth are heightening, with a progressive increase in volatility and less appetite for risk. Uncertainty over the start of the process of interest rate rises by the US Federal Reserve are also contributing to this climate.

... that was greater on the emerging markets,...

On the emerging markets, the level of uncertainty increased to a greater degree and in a more generalised fashion, since the repercussions of the developments in the Chinese market are more immediate and the effect that any future rise in US interest rates may have is more marked. Further, the appreciation of the dollar tends to make debt service and refinancing by companies in those countries that resorted to dollar funding more expensive.

... against a background of weak global economic growth...

The current macroeconomic scenario for the global economy is characterised by a moderate recovery in activity in the main advanced regions (still weak in some cases, such as in the euro area and Japan) and by the continuation of the slowdown in the emerging economies. Various factors are contributing to this latter development, some of which structural, and some such as the prolonged reduction in commodities prices, which is acutely affecting the activity of the commodities exporting countries.

...and low inflation rates in the advanced and emerging economies alike

Inflation in the advanced economies has continued falling, standing at very low levels and, generally, clearly below central banks' medium-term targets. The pace of price increases has also held low in a good number of the emerging economies (especially in Asia and Europe), although in other cases, such as Latin America, Russia and Turkey, there has been considerable downward stickiness, partly as a result of the depreciation of these countries' currencies. Significantly, the room available for macroeconomic policies in these economies to withstand a more unfavourable environment is less than in previous episodes.

The baseline scenario envisages recent trends holding...

With a view to the coming quarters, the baseline scenario envisages a continuation of recent trends, with an appreciable increase in the overall level of uncertainty. For the advanced economies as a whole a modest increase in growth is expected, assisted by low commodities prices (of which these countries are net importers) and favourable financing conditions. In the case of the emerging economies the projections are more heterogeneous, but part of a general pattern of weakening in which the slowdown in the Chinese economy, continuing low commodities prices and the incipient tightening of global financial conditions have been particularly influential. This aforementioned tightening might hamper the ongoing adjustment of those economies where lending and investment most grew in the previous cyclical upturn.

... and the main risks refer to the slowdown in the emerging economies and a possible correction of financial asset prices

The main risks to this baseline scenario for the international economy and financial markets are of two types. The first refers to the potential scope of the slowdown in the emerging economies, which appears to have stepped up in recent months. The second relates to a possible sharp correction in financial asset prices. These risks, which are analysed in detail below, are not mutually exclusive, and a scenario in which both materialise together cannot be ruled out.

The slowdown in the emerging economies might be sharper than anticipated in the baseline scenario...

A common feature shared by a good number of the emerging economies is the progressive slowdown in their economic activity in recent years, with the positive growth differential they had maintained vis-à-vis the advanced economies having narrowed significantly. Broadly, the growth rate in this group of countries is increasingly lower and in each new forecasting exercise the projections have been successively cut (see Chart E in the Overview). This correction is not purely conjunctural, since the estimates of potential growth also suggest diminished dynamism which, overall, is associated with lower productivity gains and the – more incipient – emergence of demographic problems, along with certain idiosyncratic elements in some cases. These factors are starting to influence international investors' spirits and analysts' and rating agencies' assessments, which may ultimately bear down on capital flows towards these economies.

... owing particularly to the loss of momentum of the Chinese economy

Given its growing weight in and its impact on the global economy, the loss of momentum of the Chinese economy is particularly significant. China is immersed in a transition towards a growth model more geared towards consumption which, foreseeably, will lead to lower but more sustainable growth rates over time (see Box 1.1). The recent tensions originating on Chinese stock markets highlight the fact that this re-balancing process, which requires the implementation of numerous reforms, including moves towards greater financial liberalisation, is not free from risks. Indeed, it cannot be ruled out that, at least temporarily, this process may give rise to lower-than-expected growth rates, which would have a bearing on global growth and, in particular, on that of other emerging economies.

THE RISKS ASSOCIATED WITH THE ECONOMIC SLOWDOWN IN CHINA

BOX 1.1

The Chinese economy is currently undergoing a process of rebalancing. The aim is to maintain the convergence in living standards, while ensuring their sustainability, through a shift away from investment, which is high but the productivity of which is low, and exports, towards consumption. This requires, in turn, the implementation of structural reforms, which have uncertain effects in the short term, especially when introduced in a context of slowing activity, with significant levels of corporate debt and excess capacity in certain sectors.

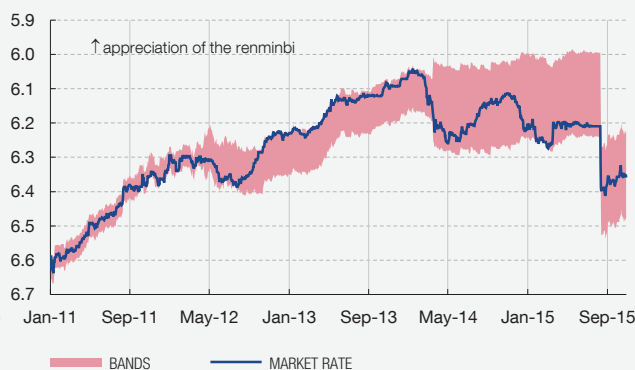
One of the key elements of this process has been financial reform, which seeks to give greater importance to the market. Against this background, various measures were adopted between November 2014 and June 2015 to open up the stock market to a larger number of investors, especially domestic ones, but also to external investors, with a connection between the Hong Kong and Shanghai markets. As a consequence of this process the Shanghai stock market rose spectacularly (see Chart A), with clear signs of over-valuation.

This led to an initial reaction by the authorities, in April, when they announced a tightening of the rules on securities lending, which was playing a fundamental role in the boom. As a result, expectations of future prices were revised, triggering a rapid decline that gathered pace during June and early July. Again the authorities intervened, this time to slow the falls. The strength of their action, which included not only reductions in reference interest rates and cash ratios, but also direct share purchases on the market, extraordinary funding for brokers and diverse restrictions on share selling, led to doubts regarding the authorities' capacity for action and the extent of the economic slowdown in China. Subsequently, in mid-August, against a background of sharply falling exports, the Chinese central bank modified the system for setting the central parity against the US dollar (see Chart B), which led to a 3% devaluation of the renminbi. This, along with a sequence of worse-than-expected data, revived the uncertainty and led to another severe stock market correction, on this occasion with international contagion, and further intervention by the authorities. Later, in October, the authorities

A SHANGHAI COMPOSITE INDEX



B US DOLLAR EXCHANGE RATE



SOURCES: CEIC and Datastream.

reduced reference interest rates and cash ratios further, while pressing ahead with financial reform by liberalising deposit rates.

There are three direct channels through which lower growth in the Chinese economy may be passed through to the global economy: the trade channel, the commodity price channel and the direct financial channel. With respect to the trade channel, the rest of Asia and Oceania are the most exposed regions. Latin America is also significantly exposed to this channel, since China is the main importer of commodities, but more important is the impact through the reduction in the prices of these products, which may be accompanied by an increase in external and budgetary imbalances and a reduction in foreign investment. Within the euro area, Germany, France, Italy and the Netherlands are China's main trading partners, while direct exports from Spain represent less than 1.5% of the total, although Spanish exposure through third countries in the euro area may be higher. The direct financial channel is rather limited given that the financial markets in China remain relatively closed and the cross-border banking positions, despite being relatively large

according to the BIS statistics, represent a small proportion of the total for the most exposed advanced economies (United Kingdom 12%, Japan 5% and United States 4%). The Spanish exposure is \$10 billion (less than 1% of the total).

The available estimates suggest that a gradual moderate slowdown in the Chinese economy, like the one envisaged in the central scenario, would have limited effects through the trade channel (strongest in the case of the Asian economies) and through the one that operates via commodity prices (with the most pronounced effects in this case on the exporters of such products), and a very limited direct financial impact.¹ However, if the slowdown in the Chinese economy is sharper than anticipated and persistent, the indirect financial channels — principally contagion through greater risk aversion or a deterioration in confidence — could be more important.

¹ See, for example, Banco de España (2015): "Transmisión internacional del reequilibrio económico de China", the second box of the Quarterly report on the Spanish economy, *Boletín Económico*, Banco de España, September.

The domestic weaknesses in the Latin American economies have been highlighted by the recent external shocks

Against this background of slowing growth in China and falls in commodities prices, economic activity in Latin America has since 2011 been decelerating markedly, following a boom decade. These external shocks have highlighted the domestic weaknesses of the economies in the region. Some countries face a delicate situation of recession and high inflation, with little room for manoeuvre for economic policy-making.

The outlook for Brazil points to a significant contraction in activity in 2015

Such is the case of Brazil, where cyclical weakness has stepped up as a consequence of the need to apply macroeconomic adjustment policies to correct the imbalances built up during the upturn, in particular the budget deficit, the external deficit and inflation. The outlook for this country points to a significant contraction in activity over the rest of 2015, against a backdrop of fiscal adjustment, exacerbated by political tensions (as already prompted by one agency's downgrading of the country's rating to below investment grade), a harsher monetary policy and a relatively unfavourable international environment, which includes a tightening of international financing conditions. The exchange rate, which has depreciated by 50% in real effective terms since 2011, is acting as an initial adjustment

mechanism, although its corrective effect on the current deficit is still limited and, by contrast, it is exerting some pressure on the inflation rate. Foreseeably, next year will see a greater effect by the currency's depreciation on external demand and an improvement in private consumption, arising from the reduction in inflation, which will soften the decline in activity. In the medium term, it is to be expected that the macroeconomic adjustment under way will ultimately restore equilibrium to the Brazilian economy, although all forecasts suggest a further adjustment of activity in 2016. In any event, the country also enjoys significant strengths, such as a high level of international reserves, an appropriate macroeconomic policy framework and a healthy banking system with high levels of solvency, liquidity and profitability, and a low level of NPLs.

The effect of the external shocks extends to other emerging economies such as Turkey, where economic fragility is exacerbated by political tensions

The effect of the external shocks is not confined to Latin America, but extends to other emerging economies with some type of vulnerability. This is the case of Turkey, where economic fragility is compounded by tensions in the political realm. On the economic front, the Turkish current-account deficit has been high in recent years (5.8% of GDP in 2014), which has led to a significant increase in its external debt. External financing largely comprises short-term capital flows, which makes the country particularly sensitive to a potential reversal of such flows, to a rise in financing costs or to an excessive depreciation of the lira. External funding is routed through the Turkish banking system which, therefore, poses a high credit risk, derived from non-financial corporations' foreign currency exposure. That said, the banking system's solvency and profit ratios are sound, default levels are low and public finances are very healthy.

Financial markets posted discrete and frequent rises in volatility

Recent months have seen a rise in volatility on the main financial markets. As can be seen in Chart 1.1, the volatility of exchange rates has increased gradually since late 2014; but uncertainty has also fed through to the bond markets, with a slight and progressive rise in the implied volatility on US government debt markets at different maturities. More recently, since August 2015, there has been a strong increase in volatility in equity indices.

Against this background, larger-scale adjustments in financial asset prices cannot be ruled out

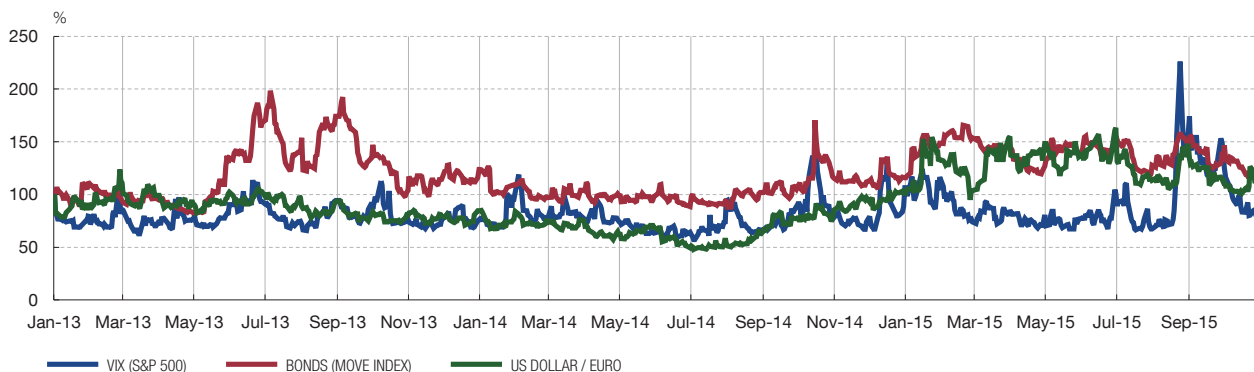
Against this background, larger-scale and longer-lasting adjustments in financial asset prices cannot be ruled out, and they may be amplified should liquidity problems arise on secondary markets. This might ultimately impact financial institutions' income statements and their funding costs, with unfavourable consequences for the spending and investment decisions of households and non-financial corporations.

The recent increase in volatility is in response to various...

The recent increase in volatility appears to be in response to doubts over the ability gradually to implement change in the monetary conditions in certain countries, in particular

IMPLICIT VOLATILITIES

CHART 1.1



SOURCE: Datastream.

...factors such as the downward revision of global growth expectations, expectations about US monetary policy and the situation of the Chinese economy...

the United States, and to the downward revision of global growth expectations. Both factors might ultimately trigger episodes of asset price corrections. In any event, the sharpness of the oscillations will depend on market characteristics. In those markets with a lower level of liquidity (such as the corporate bond market), or with operational constraints (as is the case with some of China's stock markets), rises in volatility in the face of adverse surprises may be more acute than before the crisis. There might also be upward adjustments in the credit risk premia of certain instruments that are currently at low levels, as is the case with corporate debt (see Chart 1.2.A for the United States), or the implied term premia on the government debt yields of the main developed economies (see Chart D of the Overview for the United States). The equity markets also reflect this greater uncertainty, as evidenced by the severe correction the main stock market indices underwent in August and September in the advanced and emerging economies alike (see Chart 1.2.B).

... which also affect international bank funding markets

International bank funding markets are no less affected by these circumstances. Chart E in the Overview shows how, following several years of declines, bank debt spreads have gradually increased across the board since summer 2014, more sharply so in the case of the United States. The greater rise in the US spread might be due to idiosyncratic factors, such as the effect of sanctions and fines for various instances of fraud, or slowing profits from investment banking activities. In any event, it cannot be ruled out that, in the current context of greater risk aversion, there may also be significant corrections in these markets.

1.2 The euro area

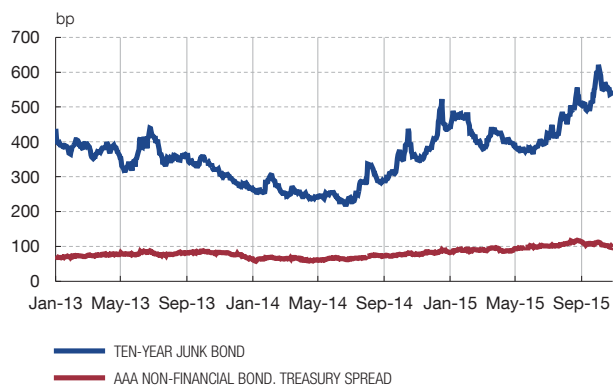
In the euro area there were also bouts of tension on financial markets, which were more acute and durable in the case of stock markets

Developments on euro area financial markets in the final stretch of Q2 were marked by the difficult negotiation of the agreement to extend a third support package for Greece. This episode gave rise to increases in volatility, stock market price declines and increases in the sovereign debt yields of certain countries with respect to Germany. That said, contagion to the rest of the euro area was contained, especially when compared with the market reaction in previous episodes. Among other factors, headway in recent years in governance and in the development of new crisis-management instruments in the euro area were no doubt a contributing factor here. Following the signing of the agreement between the Greek authorities and the credit institutions, on 12 July, the previous movements tended to be reversed, although subsequently European markets were adversely affected by the global factors mentioned in the foregoing section. More recently, asset prices have tended to rise, a development partly related to expectations over further expansionary measures by the ECB.

STOCK EXCHANGE INDICES AND US INTEREST RATE SPREADS

CHART 1.2

A US INTEREST RATE SPREADS



B STOCK EXCHANGE INDICES



SOURCES: Datastream and JP Morgan.

Overall, from late April to late October, stock market indices posted moderate declines and the average premia on the CDSs of financial and non-financial corporations rose slightly. Much of the previous increase in 10-year sovereign bond yields has recently been corrected, whereby they still stand at levels slightly up on those in late April.

Except in the case of term premia, there are no signs that euro area risk premia are at exceptionally low levels

The credit risk indicators in respect of corporate and sovereign bonds are close to the lowest levels of recent years, albeit clearly above those of the period in the run-up to the onset of the crisis in 2007. From that standpoint, these premia would not seem to be exceptionally low. On euro area stock markets, the valuation measures that take into account the business cycle juncture, such as the cyclically adjusted price/earnings ratio, do not show clear signs of overvaluation. By contrast, the estimates available on the term premia on public debt suggests that, despite having recently risen, they are currently at historically low levels, a development that may be partly related to the Eurosystem's non-standard expansionary monetary policy.

Financing conditions remained favourable

Financing conditions remain favourable. In particular, on the credit market, the interest rates applied by banks to customers – on the latest information available, for August – were at historically low levels. Dispersion across countries has fallen significantly since the announcement of the new Eurosystem policy measures in June 2014.

The mild economic recovery in the euro area continues and inflation is once again in negative territory

The latest available information on euro area GDP growth shows a quarter-on-quarter increase, in 2015 Q1 and Q2, of 0.5% and 0.4%, respectively (see Chart 1.3.A). Inflation, measured by the year-on-year rate of change in the HICP, returned to negative figures in September (–0.1%), after several months of positive rates, owing to the recent fall in energy goods prices.

The ECB revised its growth and inflation outlook slightly downwards, while signalling the presence of predominantly downside risks...

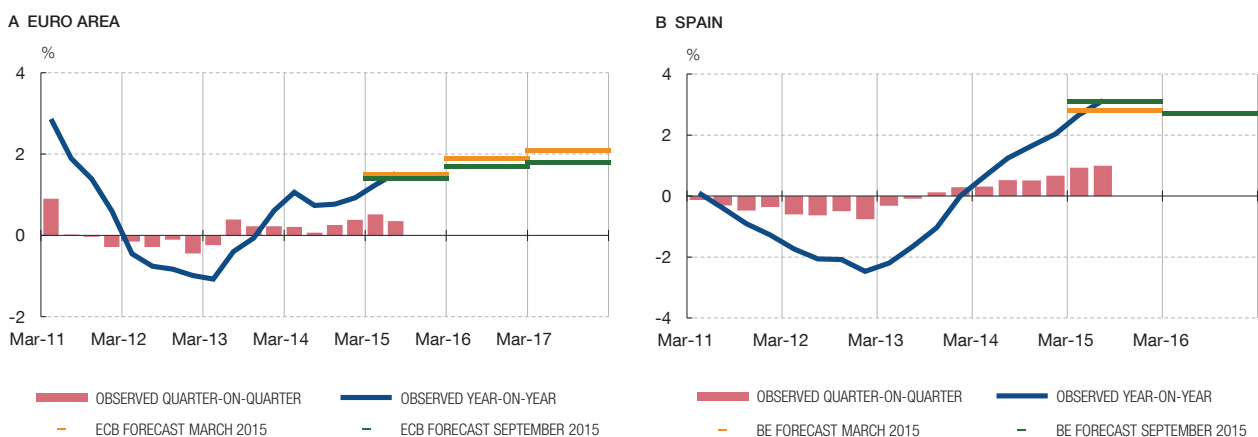
The latest ECB forecasts (September) point to a continuation of the gradual recovery in economic activity and to inflation rates progressively drawing closer to their medium-/long-term objective. However, the greater uncertainty prompted by recent developments in the emerging markets led the ECB to revise its outlook for both growth and prices slightly downwards and, above all, to signal the presence of predominantly downside risks in the case of both variables with respect to their baseline scenario. The latest available information appears to confirm these risks.

... and announced its readiness to act if necessary

Against this background, the ECB Governing Council reiterated on 3 September its intention to maintain its asset purchase programmes under the initially announced monthly volume and duration terms, and it further recalled the flexibility at its disposal to adjust,

GDP GROWTH AND FORECASTS

CHART 1.3



SOURCES: INE, Eurostat and Banco de España.

where appropriate, the volume, composition and duration of the programmes, evidencing its readiness and ability to act if required.¹ Subsequently, in the statement for the meeting on 22 October, it recalled its readiness to use, where necessary, all the monetary policy instruments at its disposal.

Currently, the main risks in the euro area are: a less-favourable-than-expected macroeconomic picture globally...

From the standpoint of financial stability analysis, the main aggregate risks are qualitatively similar to those previously indicated in the context of the external setting of the euro area. Moreover, as a factor of risk of particular interest to the euro area, the potential negative impact that a less favourable global setting may have on long-term inflation expectations should be highlighted. In this respect, the lower nominal growth that would ensue in a scenario of less buoyant activity and very low inflation would tend to slow the rate of correction of the debt levels of those agents (public and private alike) that are still in a vulnerable financial position, which might bear down adversely on investor confidence.

... and a possible sharp correction of prices on financial markets

Any future sharp correction of prices on financial markets, whether because of factors external to the euro area (such as those linked to an increase in risk aversion on international markets) or internal factors (such as a possible downturn in confidence within the euro area), would entail rather significant risks for the euro area economy, as it would involve a tightening of financing conditions. In a risk scenario of these characteristics, any future tightening on financial markets might exert an adverse impact on the area's economic prospects along with asymmetric effects that would compound such impact, with a particularly significant effect on those agents or economies in a situation of greater financial vulnerability and/or with greater macroeconomic imbalances.

1.3 The Spanish economy

As in the euro area, corporate credit risk premia rose and stock market prices fell on domestic financial markets

In Spain, developments on domestic financial markets were, in general, in line with those in the rest of the area, although the rise in average 5-year CDS premia in the case of financial and non-financial corporations was somewhat higher in Spain (around 30 bp, compared with 0-20 bp on average in the euro area). Spanish 10-year government bond spread over the German benchmark rose above all at times of high tension, although it subsequently turned down, returning in late October to levels similar to those in late April (around 115 bp). The Ibx 35, for its part, fell 8% during this period.

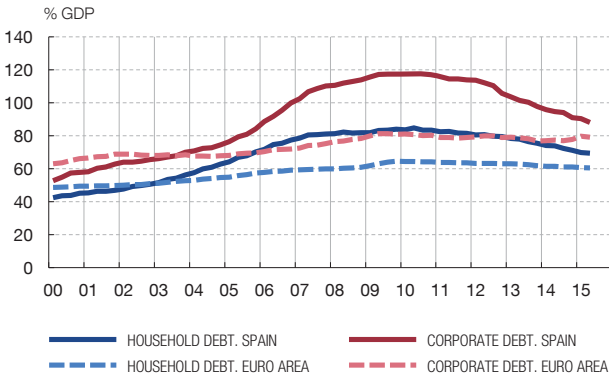
The significant growth rate of economic activity began to show signs of easing in Q3 and inflation turned negative again owing to the effect of oil prices

Underpinned above all by national demand, Spanish GDP posted significant positive growth in quarter-on-quarter terms in the first two quarters of 2015, of 0.9% and 1%, respectively, placing the year-on-year growth rate in Q2 at 3.1%. On the latest available information, a slight containment of the pace of output is expected to have begun in Q3, as a result of the progressive exhaustion of some of the factors which, temporarily, forcefully drove national demand during the final stretch of 2014 and the first half of 2015. As regards prices, on the latest available provisional data the year-on-year rate of change of the CPI stood at -0.7% in October, a fall chiefly due to the behaviour of energy prices.

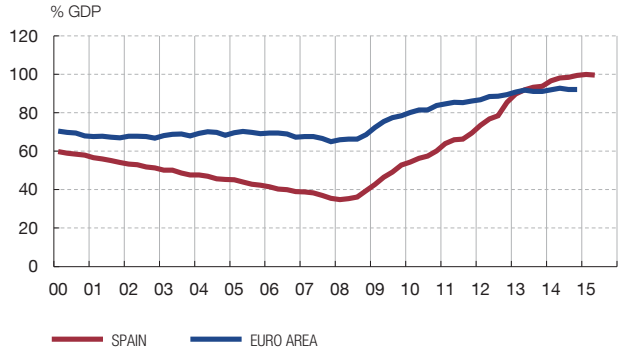
The latest projections published by the Banco de España, in late September, point to average GDP growth in the baseline scenario of 3.1% for 2015 as a whole, whereas a somewhat more moderate rate of increase is expected in 2016 (2.7%; see Chart 1.3.B). On the prices front, the CPI is expected to rise slightly at the end of this year and thus embark on a path of gradual increases over the course of 2016, which would nonetheless be compatible with moderate inflation rates for the year as a whole.

¹ The ECB further decided to raise, in general terms, the ceiling on the securities of each individual issue that may be acquired by the Eurosystem, from 25% to 33%. This measure contributes to heightening the potential headroom for extending the programme where necessary.

A PRIVATE INDEBTEDNESS RATIOS



B PUBLIC INDEBTEDNESS RATIOS



SOURCE: Banco de España.

Despite the notable progress made in correcting its imbalances, the Spanish economy is vulnerable to a scenario of lower nominal growth in the euro area...

The risks to this scenario largely coincide with those indicated for the euro area. In this respect, the Spanish economy is particularly vulnerable to a scenario of lower nominal growth in the euro area, insofar as this would hamper seeing through the adjustments outstanding in respect of the main macro-financial imbalances. In particular, despite the fact the ongoing deleveraging of households and non-financial corporations is at a very advanced stage, the debt of these sectors remains high and still above the euro area average (see Chart 1.4.A). The budget deficit has diminished notably in recent years, but it is still at levels that entail sizeable financial needs on the part of overall general government, whose debt ratio has begun to show signs of stabilising, although its current level is very high (see Chart 1.4.B).

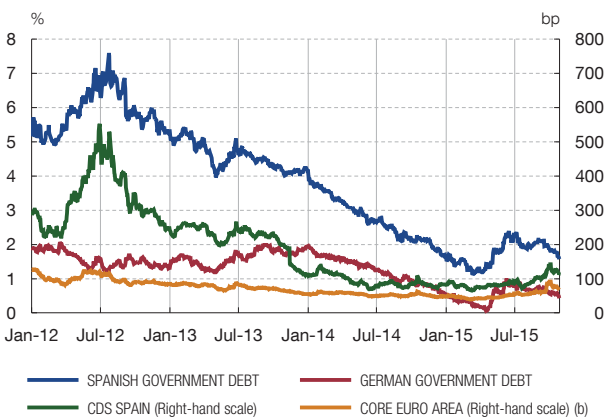
... and to a possible tightening of financing conditions

Against this backdrop, a possible tightening of financing conditions might significantly affect the Spanish economy, given the still-high financing requirements for the nation as a

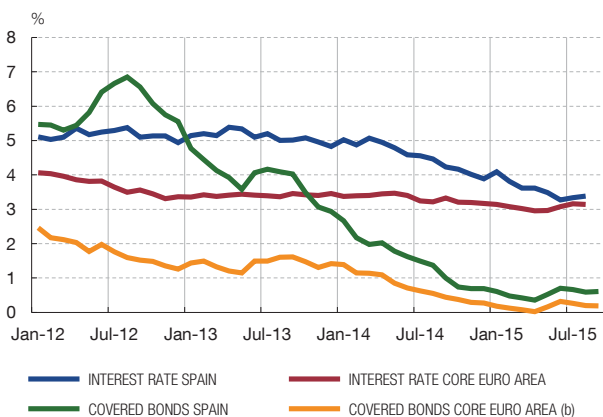
FINANCING CONDITIONS IN SPAIN

CHART 1.5

A TEN-YEAR GOVERNMENT BOND YIELDS AND FIVE-YEAR NON-FINANCIAL FIRM CDS SPREAD (a)



B COVERED BOND YIELDS BETWEEN FIVE AND SEVEN YEARS (c) AND INTEREST RATE (NDR) OF NON-FINANCIAL FIRM LOANS UNDER ONE MILLION EURO (d)



SOURCES: Reuters, Datastream, European Central Bank and Banco de España.

- a Series built by weighting the CDS spreads of the Itraxx Europe index firms based in each country by their market value at the 31 December of the previous year.
- b Defined as the aggregate weighted by market price GDP in the same year of Germany, Austria, Netherlands, Finland and Luxembourg. In 2015, the 2014 GDP is used.
- c Series built for each country as the average of the interest rates of the covered bonds included in the J.P. Morgan Maggie index.
- d Average of interest rates at different terms, weighted in all instances by the relative weights of transactions in Spain.

whole. Indeed, at present the nation's debtor position vis-à-vis the rest of the world is somewhat over 90% of GDP, far above that of the core euro area economies. It is worth recalling that the generalised improvement in the Spanish economy's financing conditions has been one of the main contributing factors to the economic recovery under way. Thus, since coming to a head in mid-2012, the financial fragmentation problems in the euro area have abated significantly in Spain's case, meaning that private-sector financing costs have tended to converge towards the levels prevailing in the core euro area economies (see Chart 1.5). This is largely the result of the application of a highly expansionary monetary policy by the ECB, but also of the reforms undertaken domestically, along with the progress in terms of the economic and monetary union. This suggests that a substantial part of the recent improvement in our economy's financial position is structural in nature and, therefore, it may be expected to last over time. Even so, a possible deterioration in domestic financial conditions resulting from factors external to our country, such as those described above, or from idiosyncratic elements cannot be ruled out. Among the idiosyncratic elements, mention should be made of the risk of potential bouts of losses in investor confidence arising from doubts over the country's capacity to carry out the adjustments still outstanding, as regards both restoring the main macro-financial equilibria and bringing about structural improvement in the functioning of factor and product markets.

2 BANKING RISKS, PROFITABILITY AND SOLVENCY

Lending

2.1 Banking risks

2.1.1 CREDIT RISK

The consolidated balance sheet as at June 2015 grew owing to business abroad, partly as a result of exchange rates

The financial autonomy of subsidiaries abroad means that the risk associated with this business is limited

The tension in China and Brazil has not so far had a significant effect on bank balance sheets

Financing to the private sector, which includes credit and debt securities, grew by 3.2% year-on-year as at June 2015

Financing to general government grew by 6.4%, and its weight in the balance sheet increased

The consolidated total assets of Spanish deposit institutions, which include both their business in Spain and that of their subsidiaries and branches abroad, amounted to €3,662 billion in June 2015. They thus grew by 3.6% year on year (see Table 2.1), continuing the upward trend initiated in December 2014. This growth reflected the performance of business abroad, where total assets in June 2015 were up by 17.8% on the same month a year earlier. In Spain, however, business contracted by 2.9% in year-on-year terms, compared with a decline of 8.8% a year earlier.

These developments meant that the weight of business abroad in the total business of Spanish deposit institutions, measured in terms of assets, amounted to 35.9%, up more than 4 pp on the same month a year earlier. Behind this change is not only the performance of the banking business itself, but also the behaviour of exchange rates. Particular mention should be made of the greater importance of Spanish banks' business in the United Kingdom and the USA (see Chart 2.1.A) and of the euro's depreciation against the currencies of these countries by 11.2% and 18%, respectively.

Also, Spanish banks operate abroad through financially autonomous subsidiaries engaging mainly in local retail banking in local currency (see Chart 2.1.B), which significantly reduces the risks derived from such operations. Moreover, from the standpoint of credit risk, at June 2015 the total non-performing loans ratios¹ associated with the credit granted in these countries remained steady, standing substantially below 2% in the United Kingdom and the USA (see Chart 2.1.C). This non-performing loans ratio has behaved favourably in both these countries, in line with the macroeconomic trend analysed in Chapter 1 (see Chart 2.1.D).

Spanish banks' exposure to China is scarcely 0.4% of their total assets abroad, and is divided in similar proportions between business in local currency and that in non-local currency. Therefore, the tensions stemming from movements in the value of the yuan and the possible deceleration of the Chinese economy have a very limited direct effect on Spanish banks' balance sheets. Further, the entry into recession of Brazil, one of the main sources of risk in emerging countries as explained in Chapter 1, does not yet seem to have had an impact on the non-performing loans ratio.

Financing to the private sector, which includes credit and debt securities, grew by 3.2% year-on-year as at June 2015. In terms of total assets, it rose from 61.4% at June 2014 to 61.1% a year later. The change in credit to the private sector resulted from the notable growth (by nearly 20%) of banks' business abroad, in contrast to the moderate decrease in Spain. As mentioned above, the behaviour of exchange rates in the past year has significantly affected the performance of business abroad.

Financing to general government (credit and fixed income) posted a year-on-year increase of 6.4% at June 2015, which raised its weight in the balance sheet by 0.4 pp to 15.1% in the past year. This increase took place both in business in Spain (2%) and, more sharply, in

¹ In addition to credit and NPLs to the resident private sector, this figure includes those to general government and credit institutions.

CONSOLIDATED BALANCE SHEET.
Deposit institutions

CHART 2.1

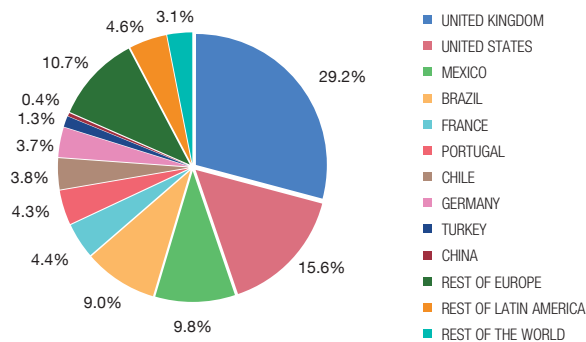
Assets	Jun-15		Jun-14	Jun-15
	€m	% Change Jun-15/Jun-14	% ATA	% ATA
Cash and balances with central banks	120,382	-2.7	3.5	3.3
Loans and advances to credit institutions	166,707	-7.5	5.1	4.6
General government	115,326	6.2	3.1	3.1
Other private sectors	2,104,731	4.0	57.3	57.5
Debt securities	618,531	0.9	17.3	16.9
Other equity instruments	53,043	19.0	1.3	1.4
Investments	39,893	-7.3	1.2	1.1
Derivatives	173,414	3.0	4.8	4.7
Tangible assets	55,929	6.2	1.5	1.5
Other (a)	214,376	22.7	4.9	5.9
TOTAL ASSETS	3,662,333	3.6	100	100
Memorandum items				
Financing to private sector	2,237,501	3.2	61.4	61.1
Financing to general government	551,875	6.4	14.7	15.1
Total NPLs	177,686	-16.8	6.0	4.9
Total NPL ratio	5.9	-137 (d)		
Loan loss and country risk provision (b)	-106,303	-14.0	-3.5	-2.9
Liabilities and equity	Jun-15		Jun-14	Jun-15
	€m	% Change Jun-15/Jun-14	% ATA	% ATA
Balances from central banks	201,686	7.9	5.3	5.5
Deposits from credit institutions	366,839	-4.3	10.9	10.0
General government	107,506	1.5	3.0	2.9
Other private sectors	1,865,518	5.6	50.0	50.9
Marketable debt securities	379,724	-4.9	11.3	10.4
Derivatives	174,359	7.1	4.6	4.8
Subordinated debt	50,684	9.7	1.3	1.4
Provisions for pensions, tax and other	35,991	3.6	1.0	1.0
Other (a)	214,426	7.5	5.6	5.9
TOTAL LIABILITIES	3,396,731	3.4	93.0	92.7
Memorandum items				
Eurosystem net lending (c)	135,735	-12	4.4	3.7
Minority interests	27,719	-8.7	0.9	0.8
Valuation adjustments relating to total equity	-10,864	.	-0.3	-0.3
Own funds	248,747	8.7	6.5	6.8
TOTAL EQUITY	265,602	6.8	7.0	7.3
TOTAL LIABILITIES AND EQUITY	3,662,333	3.6	100	100

SOURCE: Banco de España.

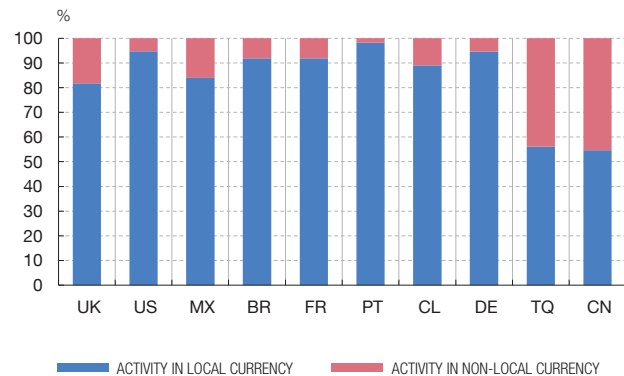
- a** The remaining assets and liabilities entries not explicitly considered, including valuation adjustments, are included in "Other".
b In addition to country risk provisions, it includes specific and general provisions for credit risk.
c Difference between funds received in liquidity providing operations and funds delivered in absorbing operations. September 2015 data (latest available) and September 2014 data to maintain the year-on-year comparison.
d Difference calculated in bp.

business abroad (21.3%). In terms of total assets, financing to general government amounted to 15.1%, this weight having risen in recent years, particularly in business in Spain. Since the beginning of the crisis, financing to general government has gained weight in terms of total assets, while financing to the private sector has lost weight. This trend can be expected to

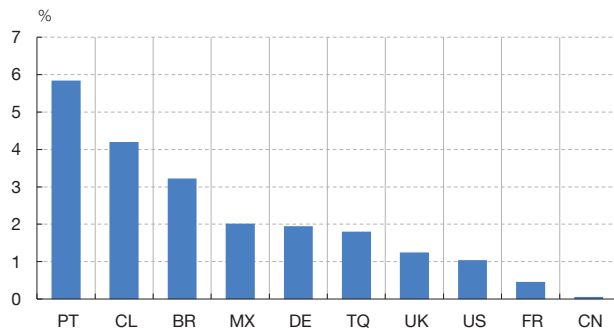
A GEOGRAPHICAL BREAKDOWN OF FINANCIAL ASSETS ABROAD



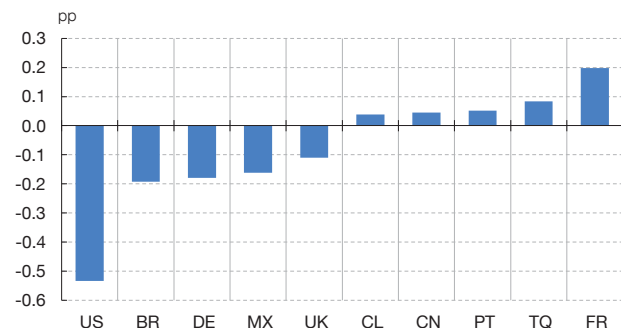
B BREAKDOWN OF COUNTRIES' ACTIVITY, BY CURRENCY



C TOTAL NPL RATIO OF FINANCIAL ASSETS ABROAD, BY COUNTRY (a)



D YEAR-ON-YEAR CHANGE IN TOTAL NPL RATIO OF FINANCIAL ASSETS ABROAD (a)



SOURCE: Banco de España.

a The total NPL ratio of consolidated financial assets abroad includes NPLs to credit institutions, general government and the private sector.

reverse as the economic recovery moves onto a firmer footing and credit to the private sector increases. However, given the high weight which financing to general government currently has in bank balance sheets, a sudden significant increase in sovereign debt yields, which is a risk identified in the analysis of Chapter 1, would have a negative impact on banks.

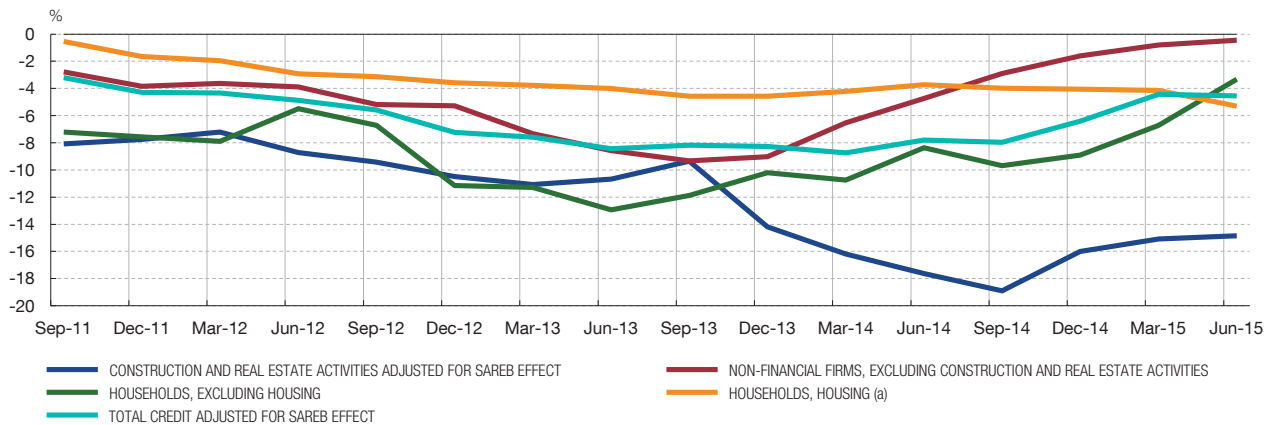
Credit to the resident private sector in Spain continued to fall in 2015, albeit more slowly than in the previous year...

Analysis of banking business in Spain shows a year-on-year decrease in credit to the private sector of 4.5% at June 2015 for deposit institutions as a whole (see Chart 2.2.A). This continues the trend of recent quarters in which the volume of credit has been decreasing, although at a progressively slower pace (the year-on-year rate of change of credit at June 2014 was -7.8% and at December 2014 it was -6.4%). This smaller fall in credit was widespread across banks (see Chart 2.2.B). The most recent monthly data, relating to August, point to a further continuation of this trend, with a year-on-year decrease of 4.4%.

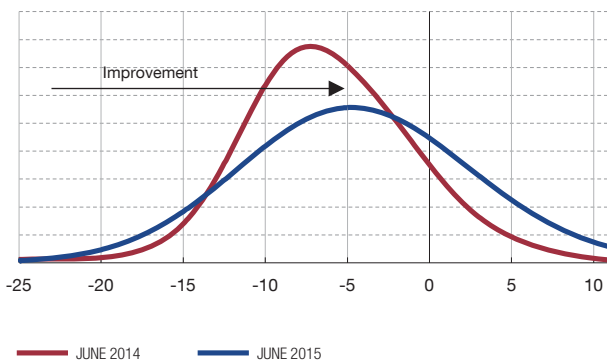
...due to the slower contraction in that to non-financial corporations...

The latest available quarterly data show a year-on-year fall of 5.7% in the volume of credit to non-financial corporations at June 2015, which is a significant improvement on the drop of 9.7% a year earlier. The decrease in credit for real estate and construction activities was 14.9% year on year at June 2015, compared with a fall of 16.7% a year earlier. The decline in other sectors was 0.5%, compared with 4.7% at June 2014. Meanwhile, household credit at June 2015 showed a year-on-year decrease of 5%, this decline being 5.3% in lending for house purchases and 3.3% in that for other purposes.

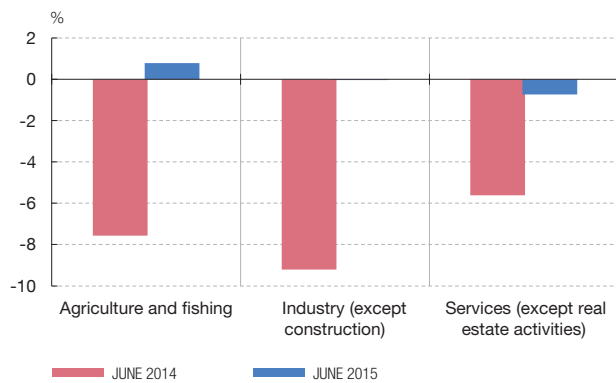
A YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR BY SECTOR OF ACTIVITY



B DISTRIBUTION OF BANK CREDIT BY YEAR-ON-YEAR RATE OF CHANGE (%) (b)



C YEAR-ON-YEAR RATE OF CHANGE IN CREDIT BY SECTOR OF ACTIVITY. NON-FINANCIAL FIRMS EXCEPT CONSTRUCTION AND REAL ESTATE ACTIVITIES



SOURCE: Banco de España.

a Includes securitizations.

b The graph shows the density function (or frequency distribution) of the year-on-year rate of change of credit for deposit institutions. This density function is approximated through a kernel estimator which allows a non-parametric estimate of the density function, yielding a continuous and smoothed graphical representation of that function.

...across the board...

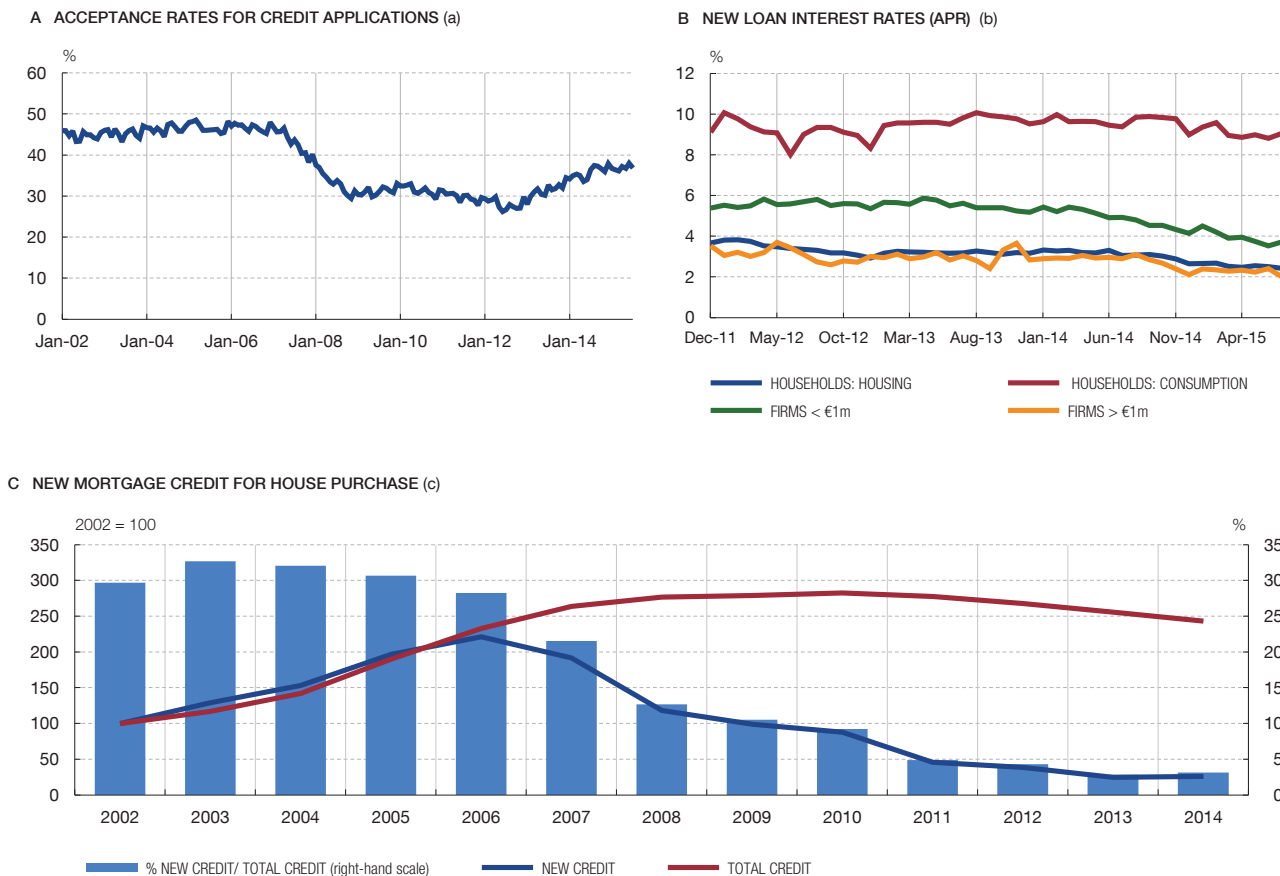
This less negative behaviour in credit to non-financial corporations for purposes other than construction and real estate activities was generally and markedly appreciable across the various sectors of activity (see Chart 2.2.C), some of which, such as the primary sector, even posted positive rates of change.

... while the growth of the loan approval rate steadied

The approval rate of the loans which non-financial corporations request from banks with which they are not working or with which they have not had a credit relationship in the preceding few months steadied at around 37%, far from the approval rates in the period of strong credit growth and those in the period of prolonged steep contraction in economic and credit activity (see Chart 2.3.A). The rate of change of loan applications continued to decelerate, although more slowly than in previous months, while the growth of approvals lost momentum. Meanwhile, the trend in construction and real estate development sector is holding firm and approval rates continue to increase.

New mortgage loans for house purchase stopped falling in 2013...

Chart 2.3.C shows the behaviour of new mortgage loans for house purchase over a long time period. This chart plots the volume of new credit (annual flow) and the volume of total mortgage credit (stock at December each year), both with base 100 from the first year that



SOURCE: Banco de España.

- a 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.
- b The new loans of a period are defined as all the first-time loans arranged with customers and all the contracts existing in earlier periods whose amount, interest rate, maturity or other significant financial conditions in relation to interest rates have been renegotiated with customers in the month in question.
- c The volume of new transactions in 2014 relates to the twelve-month period from April 2014 to March 2015, since the 2014 data are not available from January. Total credit in 2014 is taken as March 2015 figure to be consistent with the new transactions figure.

information is available (2002), and the flow of mortgage credit as a percentage of stock. It shows that the flow of mortgage credit peaked in 2006 and fell continuously until 2013. In 2014 there was a slight recovery. Also shown is the fall in the stock of mortgage credit since 2010. Lastly, the weight of new loans in total credit decreases significantly, since in the initial years of the series it is around 30% and in the final years it is about 3%.

...and have been increasing since 2014

Chart 2.3.C clearly shows the swings of the credit cycle in Spain over the past decade. The excessive credit growth caused an unsustainable expansion of the housing market, the collapse of which had an adverse impact on banks and on the Spanish economy as a whole. At prudential policy level, this highlights the need for tools able to smooth the credit cycle and leading indicators for early assessment of risks and vulnerabilities.

The cost of new lending by banks continued its moderate decline...

In the first half of 2015 interest rates on new loans by Spanish deposit institutions continued on the moderate downward path initiated in 2014, reflecting a relative improvement in credit conditions available to households and non-financial corporations (see Chart 2.3.B). The difference between the interest rates charged to non-financial corporations on new loans of more than €1 million and on those of less than €1 million has decreased in the year elapsed so far, owing to the larger reduction in rates on smaller loans.

... in parallel with the decrease in the risk premium on sovereign bonds

This decrease in interest rates, particularly those charged to small and medium-sized enterprises (loans of less than €1 million), ran parallel to the decrease in the risk premium on sovereign bonds and on bank financing, so that the improvement in the financing conditions of the Spanish economy on the international markets has spread to the private sector. In any event, as pointed out in Chapter 1, if there were a sustained change in the trend of the risk premium on these markets, that increase would foreseeably feed through to the cost of credit to households and firms, posing a risk to the recovery of credit growth and to the firming of the recovery of the Spanish economy.

Non-performing loans

Non-performing loans fell due to business in Spain...

Returning to the information shown in Table 2.1, total non-performing loans² decreased year-on-year by 16.8% as at June 2015, taking their weight in the balance sheet from 6% at June 2014 to 4.9% a year later. This improvement in non-performing loans resulted from developments in business in Spain, where total non-performing loans decreased by 19.6% at June 2015, in line with the significant recovery of economic activity noted in Chapter 1. Total non-performing loans in business abroad rose by 5.1%, substantially less than total assets, so their weight in the balance sheet also fell.

...which, together with the behaviour of credit, prompted a decrease in the total non-performing loans ratio

The decrease in non-performing loans, along with the slight growth in total credit, which includes that granted to the private sector, to general government and to credit institutions, whether resident or non-resident, prompted a year-on-year decline of 137 bp in the total non-performing loans ratio at consolidated level to 5.9% as at June 2015. This non-performing loans ratio represents an improvement of 1.8 pp with respect to the peak of the series in December 2013. The non-performing loans ratio of the resident private sector performed similarly to the total NPL ratio in the past year.

Also, provisions for loan losses and country risk fell, due partly to the decrease in non-performing loans

The decrease in non-performing loans of Spanish deposit institutions was accompanied by a drop in provisions for loan losses and country risk, which showed a year-on-year rate of change of -14% as at June 2015 (see Table 2.1). This meant that the weight in total assets of this item decreased from 3.5% at June 2014 to 2.9% at June 2015.

Non-performing loans to the resident private sector in Spain continued to decrease

Non-performing loans to the resident private sector in business in Spain continued the decline seen in the last few quarters. In particular, between August 2014 and August 2015 (latest available data) they decreased by €37 billion (-20.4% year on year) for deposit institutions as a whole. The monthly change in non-performing loans shows negative figures in all months from the beginning of 2014 to date without exception (see Charts 2.4.A and B).

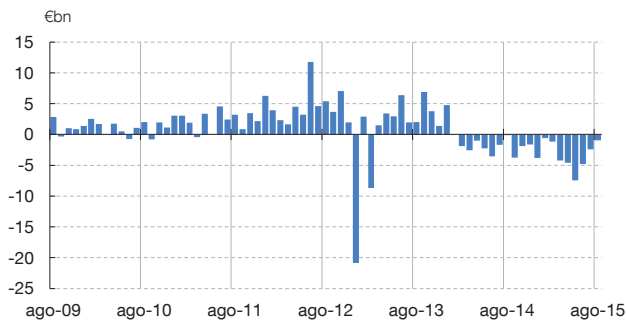
Analysis by institutional sector (see Chart 2.4.C) shows that the decrease in non-performing loans in the past year is apparent both in credit to households and in that to non-financial corporations. The year-on-year fall of 18.2% in NPLs to households contrasts with the growth of 10.9% as at June 2014. For their part, non-financial corporations reduced their non-performing loans by 20.7%, compared with NPL growth of 3.9% as at the same month of the previous year.

In the household sector, NPLs fell in house purchase credit and in other lending...

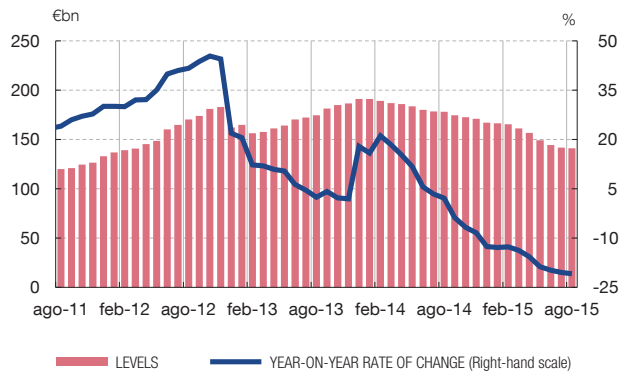
Analysis by loan purpose shows that non-performing loans to households fell similarly in credit for house purchase and in other lending (decrease of somewhat more than 18%).

² See footnote on the first page of this chapter.

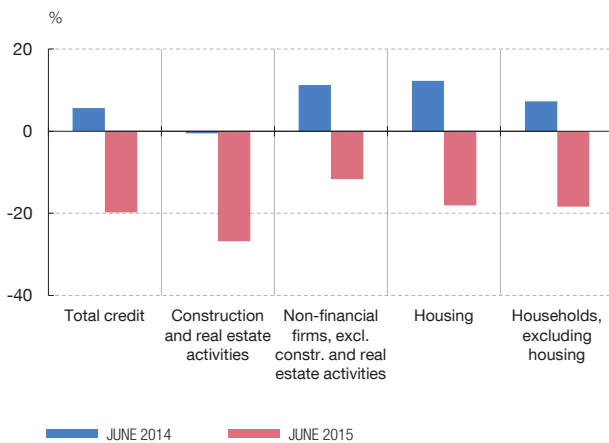
A MONTH-ON-MONTH CHANGE IN NPLs (a)



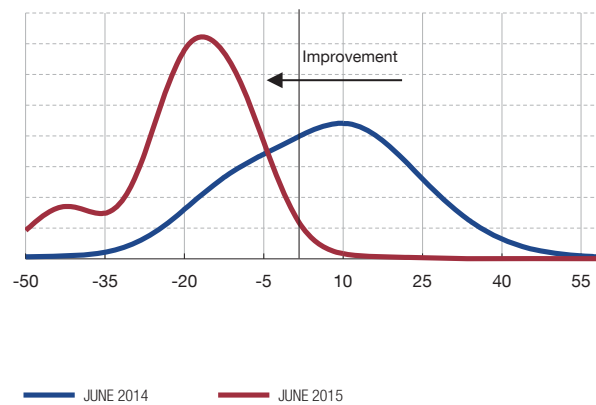
B NON-PERFORMING LOANS (a)



C YEAR-ON-YEAR RATE OF CHANGE IN NPLs, BY SECTOR OF ACTIVITY



D DISTRIBUTION OF BANK NPLs BY YEAR-ON-YEAR RATE OF CHANGE (%) (b)



SOURCE: Banco de España.

- a The transfers to Sareb by Group 1 and Group 2 banks in December 2012 and February 2013 affect the changes in those periods.
- b The graph shows the density function (or frequency distribution) of the year-on-year rate of change of credit for Spanish deposit institutions. This density function is approximated through a kernel estimator which allows a non-parametric estimate of the density function, yielding a continuous and smoothed graphical representation of that function.

In both cases there was a notable improvement with respect to the previous year, when non-performing loans grew by 12.2% in the case of house purchase credit and by 7.3% in other household lending.

... while NPLs to firms decreased both in construction and real estate activities and in other sectors

Non-performing loans to non-financial corporations decreased both in construction and real estate activities (-26.8% as at June 2015) and in other activities (-11.7%). In both cases the improvement is notable compared with the previous year. Within firms engaging in other than construction and real estate activities, the decrease in non-performing loans, as well as their faster rate of fall, was apparent in all economic sectors. Box 2.1 analyses the behaviour of non-performing loans by size of borrower firm, paying special attention to developments in SMEs.

Non-performing loans decreased at all institutions...

It should also be noted that the sharp fall in non-performing loans between June 2014 and June 2015 took place at all institutions, with a smaller dispersion at the latter date (see Chart 2.4.D).

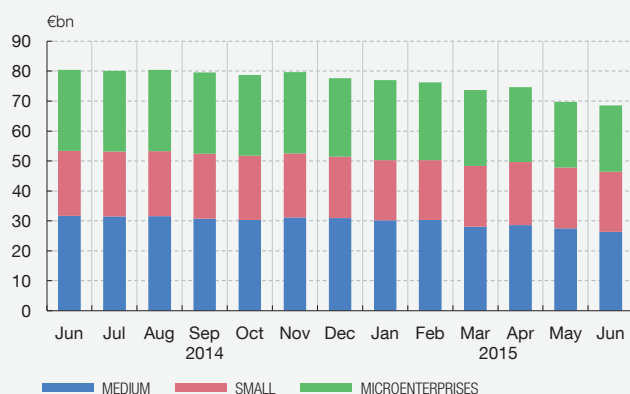
NPLs decreased over the year to June 2015, for large firms (-32.9%) and for SMEs¹ (-14.8%) and sole proprietorships (-10.1%). Among SMEs, the largest decrease was recorded for microenterprises (-18.4%), followed by medium-sized enterprises (-16.8%) and small enterprises (-7.4%)(see Chart A). Developments in the credit and NPLs of SMEs over the year to June 2015 resulted in a decline of more than 4 percentage points in their NPL ratio, from 28.1% in June 2014 to 23.9%. Even so, SMEs continue to have a higher NPL ratio than large firms, whose ratio also fell during the same period, from 18.1% to 13.9% in June 2015 (see Chart B). Breaking down the credit quality of SMEs, all the size categories recorded a fall in the NPL ratio over the year to June 2015. Moreover, size and NPL ratios are seen to be inversely related. Thus, microenterprises have the highest ratio (27.2% in June 2015), followed by small enterprises (25.5%) and medium-sized enterprises (20.9%).

In addition to these three developments, a general fall in NPL ratios between June 2014 and June 2015, higher NPL ratios for SMEs than for large enterprises and the inverse relationship between the size of the SME and its NPL ratio, differences are observed between

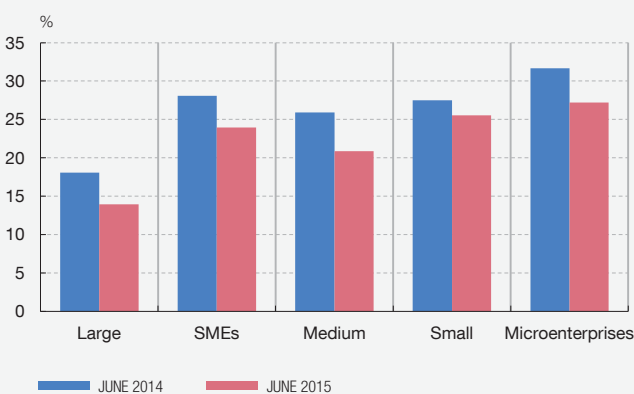
firms engaged in construction and real estate activities and other non-financial firms (see Charts C and D). In particular, there are notable differences between the level of the NPL ratios of SMEs in the construction and real-estate activities (35.8% in June 2015) and the level of the NPL ratios of other SMEs (16% in June 2015). Thus, the decline in the funding of SMEs that engage in construction and real-estate activities² basically involves a reduction in the level of risk assumed by the banks that grant credit to SMEs.

- 1 An enterprise is deemed to be an SME if it satisfies the definition in Commission Recommendation 2003/361/EC of 6 May 2003 (OJ L 124 of 20.5.03). Thus, an enterprise which employs 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 is considered to be an SME. In addition, within the SME category, a small enterprise is defined as an enterprise which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed €10 million, while a microenterprise is defined, in turn, as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed €2 million.
- 2 Credit for construction and real estate activities accounts for 40% of total credit to SMEs in June 2015, while in June 2014 it accounted for 44%.

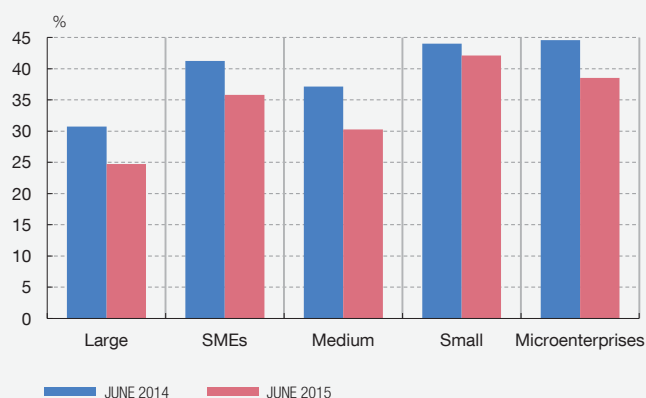
A SMEs NPLs
June 2014-June 2015



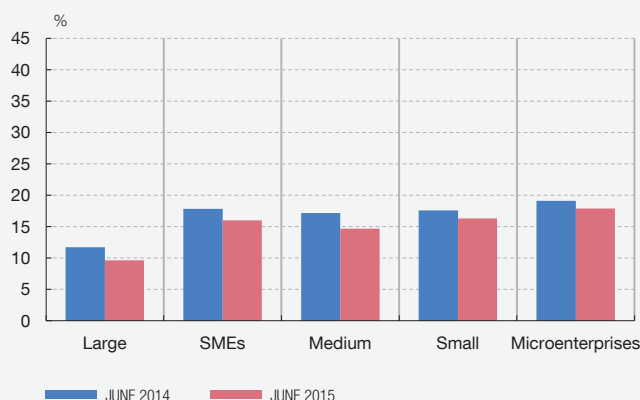
B NPL RATIO OF TOTAL NON-FINANCIAL FIRMS
June 2015



C NPL RATIO OF CONSTRUCTION & RED FIRMS
June 2015



D NPL RATIO OF NON-FINANCIAL FIRMS EXCLUDING CONSTRUCTION & RED
June 2015

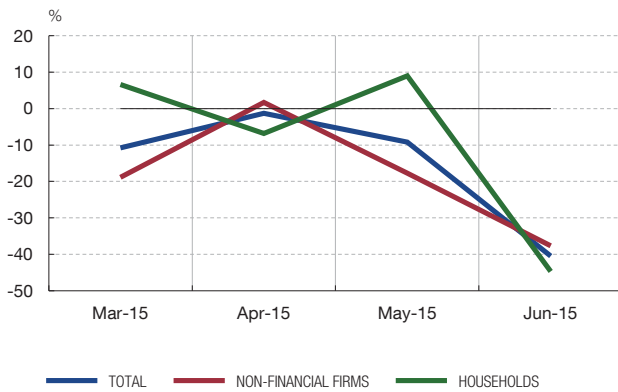


SOURCE: Banco de España.

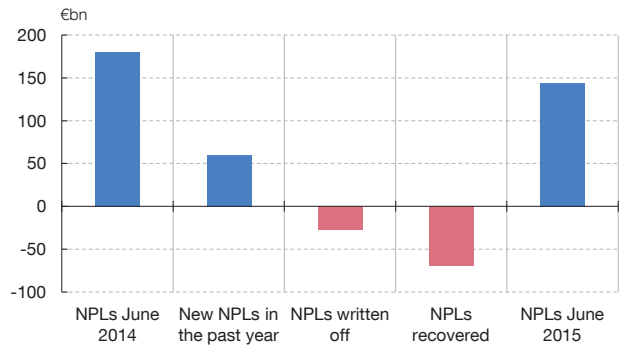
RESIDENT PRIVATE SECTOR NPLs
Business in Spain, ID. Deposit institutions

CHART 2.5

A NEW NPLs
Year-on-year rate of change



B NPLs BETWEEN JUNE 2014 AND JUNE 2015



SOURCE: Banco de España.

... and the flow of new NPLs as at June 2015 was notably lower than a year earlier

Recently, disaggregated information on flows of new non-performing loans has started to become available. It showed that new NPLs in the resident private sector in June 2015 were 40% lower than those recorded in June 2014. This decrease took place both in non-financial corporations (-37.7%) and in households (-44.7%, see Chart 2.5.A). Between June 2014 and June 2015 €60 billion of new non-performing loans were recorded, €27 billion of non-performing loans were written off and recoveries of non-performing loans exceeded €69 billion (see Chart 2.5.B)

The non-performing loans ratio performed favourably,...

The across-the-board moderation in the rate of fall of credit and, above all, the decrease in non-performing loans, enabled the non-performing loans ratio of the resident private sector in business in Spain to perform favourably in the past year. In August 2015 (latest available data) this ratio stood at 11.2% for deposit institutions as a whole (see Chart 2.6.A).

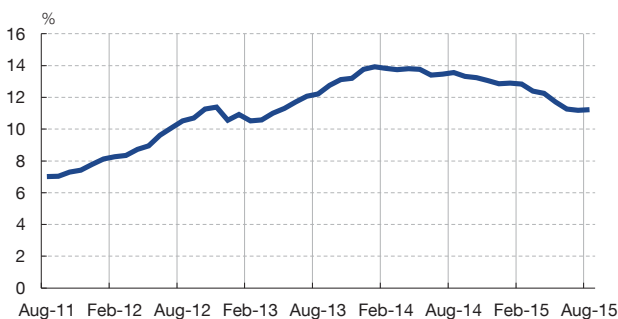
...decreasing across all economic sectors...

Sectoral analysis using quarterly data as at June 2015 (the latest available) shows that the improvement was across the board (see Chart 2.6.B). Households reduced their

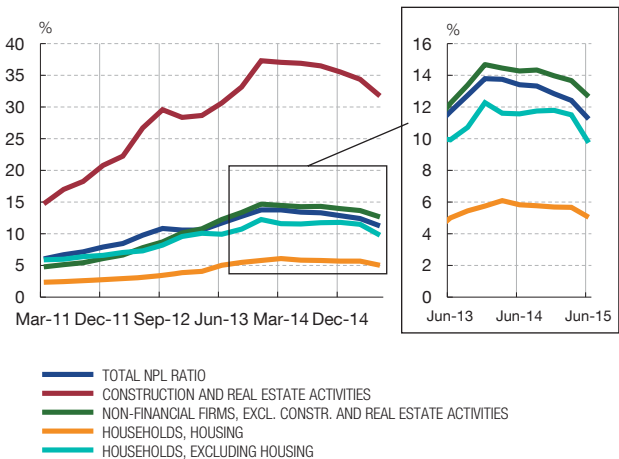
NPLs RATIO. RESIDENT PRIVATE SECTOR
Business in Spain, ID. Deposit institutions

CHART 2.6

A NPL RATIO



B NPL RATIO, BY SECTOR OF ACTIVITY



SOURCE: Banco de España.

non-performing loans ratio from 6.7% at June 2014 to 5.8% a year later. For their part, non-financial corporations saw their non-performing loans ratio decrease by 3.6 pp, from 22.6% at June 2014 to 19% a year later.

...and all loan purposes, both in households and in firms.

In credit to households, the non-performing loans ratio decreased in the past year both in house purchase loans (down 0.8 pp to 5%) and in other lending (down 1.6 pp to 9.9%). In non-financial corporations, the non-performing loans ratio decreased more steeply for construction and real estate development firms (down 5.2 pp to 31.7%) than for other firms (down 1.6 pp to 12.7%).

Foreclosure and forbearance

Foreclosed assets decreased slightly in the past year,...

Foreclosed assets or assets received in payment of debt from business in Spain which are held by Spanish banks on their balance sheets decreased slightly in the past year (by 0.9%) to €81 billion. However, as shown by Chart 2.7.A, the decrease in the last six months has been more significant, since in December 2014 the total volume of foreclosed assets was €82.5 billion, meaning that in the first half of 2015 it decreased by 2%.

...with land and completed buildings predominating

Chart 2.7.B breaks down the total volume of foreclosed assets by type of asset. 35.3% of the total is land, the weight of which has decreased by nearly 3 pp in the past year, 24.9% are completed buildings (down 1.1 pp in the past year) and 21.5% are foreclosed assets arising from house purchases (up 0.5 pp at June 2015 compared with June 2014). Finally, buildings under construction amounted to 6.6% of the total at June 2015, up 1.6 pp in the past year.

Non-performing loans and foreclosed assets are non-productive assets which put pressure on institutions' profits

Non-performing loans plus foreclosed assets amount to €224 billion of assets on the balance sheet as at June 2015 which do not generate revenue in the income statement. These two types of assets, which represent 8.7% of the total assets of banks' business in Spain, put downward pressure on institutions' income statements, reducing their profit generation.

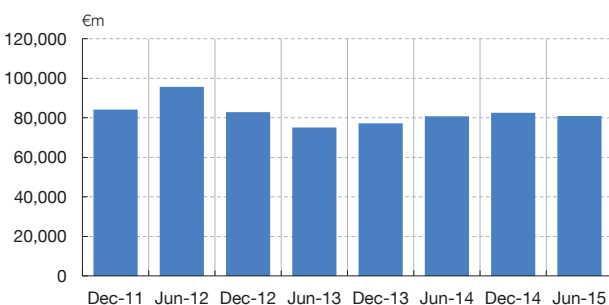
Forborne exposures in the resident private sector decreased by 15.8% in the past year to €163.8 billion...

The total forborne credit at consolidated level amounted to €211 billion as at June 2015. Of this total, 52.1% related to non-financial corporations and 45.2% to households. 2.4% of the total was credit to general government and the remaining 0.3% was to financial firms other than credit institutions. Based on data from individual financial statements, the total forborne credit to the resident private sector amounted to €163.8 billion at June 2015,

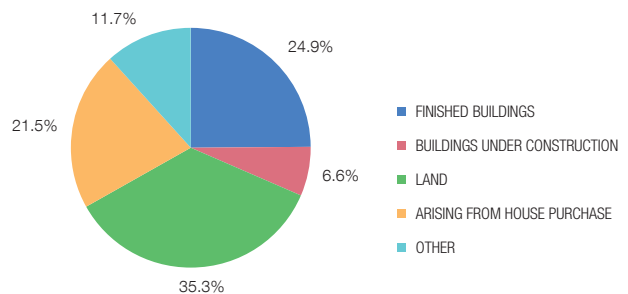
FORECLOSED ASSETS Deposit institutions

CHART 2.7

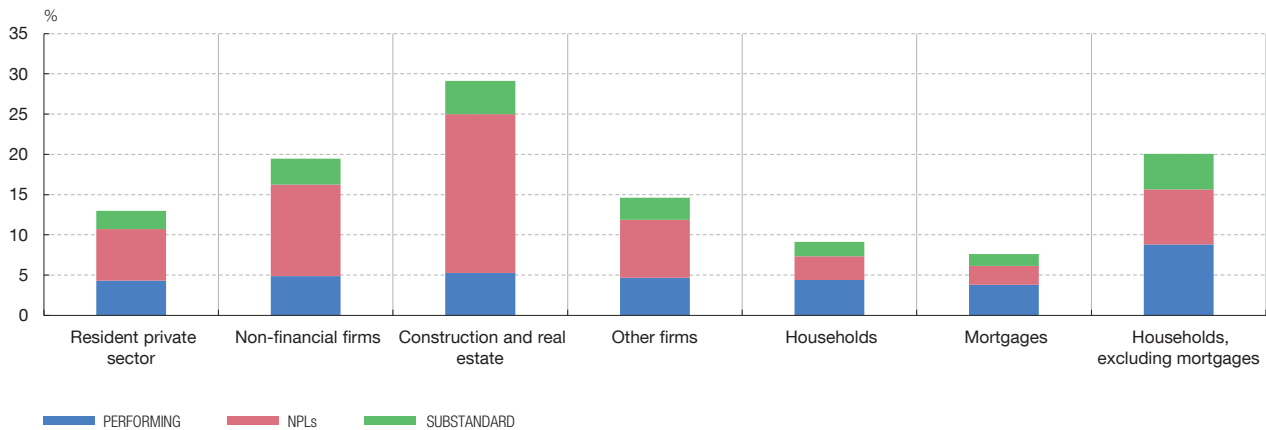
A VOLUME OF FORECLOSED ASSETS



B COMPOSITION OF FORECLOSED ASSETS.
June 2015



SOURCE: Banco de España.



SOURCE: Banco de España.

down 15.8% from the same month a year earlier. This change represents a quickening of the fall seen throughout the available time series since March 2014. The decrease in forbearance is apparent in the past year both in non-financial corporations (17.5%) and in households (13.5%). The weight of forborne exposures in total credit also declined over the last few quarters to 13% at June 2015, compared with 14.2% in the same month a year earlier (see Chart 2.8 for an analysis by portfolio type).

... of which nearly half are classed as non-performing

Within forborne exposures, those classified as non-performing at June 2015 represented nearly half of the total (down slightly by 1 pp with respect to the previous year), those classed as substandard accounted for 18% and performing loans were 33% of the total, having increased by 2 pp between June 2014 and June 2015.

Sectorally, 64% related to firms and, of these, half related to construction and real estate activities

As regards the sectoral distribution of forborne exposures, 64% of them were to firms and the other 36% to households. Within the forborne exposures to firms, half were to firms engaging in construction and real estate activities and the other half to firms with other activities. Of the 35% of forborne exposures to households, 26.2% of the total were for house purchase.

2.1.2 SYSTEMIC RISK AND FUNDING RISK

The systemic risk indicator has not risen in recent months, despite the heightened market volatility

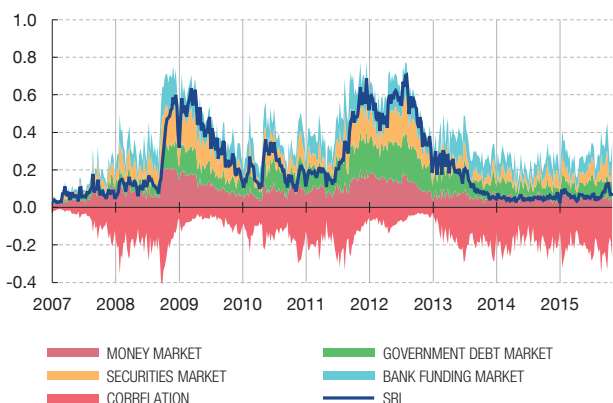
Despite the increase in volatility on the international financial markets since the last FSR, analysed in Chapter 1 above, the Spanish systemic risk indicator (SRI) has not risen significantly in recent months (see Chart 2.9.A). By and large, apart from certain specific upswings, the SRI has been contained since end-2013, holding steady in general at low levels on all the markets from which it feeds (government debt, securities, money and bank funding markets).

The CoVaR model shows a similar trend

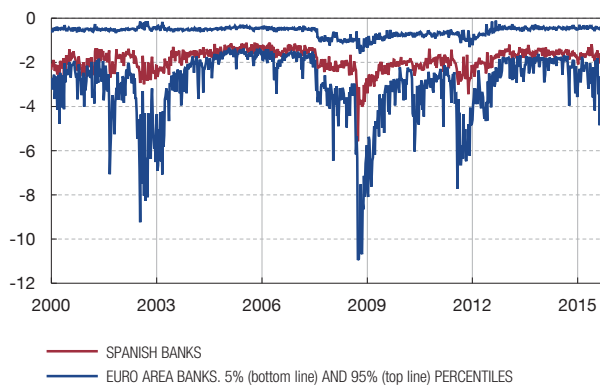
Using the CoVaR model³ it is possible to quantify the contribution that Spanish banks make to the systemic risk of the euro area as a whole. In comparison with 2014, the average CoVaR of Spanish banks has fallen slightly in 2015. However, a small uptick in systemic risk at some euro area banks can be observed in 2015, concentrated specifically in percentile 5 of the European CoVaR, meaning that the banks affected are essentially those with higher systemic risk. To date this minor change has had no significant impact on the Spanish bank average.

³ For a description of the CoVaR model, see FSR May 2015.

A SYSTEMIC RISK INDICATOR (SRI) (a)



B SPANISH BANKS' CONTRIBUTION TO SYSTEMIC RISK, MEASURED THROUGH COVAR (b)



SOURCES: Datastream, ECB and Banco de España.

- a For a detailed explanation of this indicator, see Box 1.1 in the May 2013 FSR.
- b The CoVar model is used to calculate the impact that a situation of bank stress would have on the financial system.

At consolidated level, deposits have grown as a percentage of bank funding,...

Against this backdrop of contained systemic risk indicators, analysis of bank funding at consolidated level (see Table 2.1) shows an increase in private sector and central bank deposits, while marketable securities decreased as a percentage of funding and general government increased slightly.

... while recourse by Spanish banks to Eurosystem funds has declined,...

Net recourse by Spanish deposit institutions to Eurosystem funding fell by 13% year-on-year (see Table 2.1), down to €136 billion at September 2015. The weight of Eurosystem net lending as a percentage of June total assets decreased to 3.7% at September 2015, moving closer to the levels recorded before the start of the tensions on the European peripheral sovereign debt market (see Chart 2.10.A).

... as it has at other European banks

This is in keeping with the pattern observed among other European banks, in a setting characterised by the full allotment policy in Eurosystem regular refinancing operations, in force until at least December 2016. Readier access to other funding sources has allowed European banks to continue to reduce their bids in new tenders, continuing in the pattern that first emerged in the summer of 2012. More recently, a certain degree of stability has prevailed and regular refinancing operations have been replaced by targeted longer-term refinancing operations (TLTROs). Chart 2.10.B, which illustrates the outstanding balance of ECB tenders, both for the Eurosystem as a whole and for banks resident in Spain, shows no significant changes since the last FSR. In effect, from end-April 2015 (date covered by the last FSR) to end-October, gross recourse to the Eurosystem by banks resident in Spain fell by €1.7 billion (1.2%), while the outstanding balance of the Eurosystem as a whole rose by €13.9 billion (2.7%).

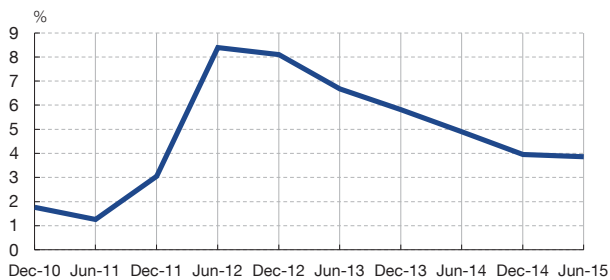
The percentage of Eurosystem lending received by Spanish banks fell in the past year

As a result, the percentage of total Eurosystem lending received by Spanish banks fell slightly in the period. The volume allotted in tenders to banks resident in Spain as a percentage of the total provided by the Eurosystem averaged 25.7% at September 2015, compared with 26.2% at April. The excess over capital key in the case of Spain has fallen by 10 pp from the maximum level observed in mid-2012.

Activity in the various segments of the euro area...

Since the last FSR, activity in the euro area interbank markets has remained weak and has even deteriorated further in its various segments, primarily as a consequence of the

A EUROSYSTEM NET LENDING AS A PERCENTAGE OF TOTAL ASSETS



B OUTSTANDING AMOUNT PROVIDED THROUGH EUROSYSTEM TENDERS (a)



SOURCE: Banco de España.

a Latest data: 29 October 2015.

...interbank markets has deteriorated further

increasingly high excess liquidity in the system. In recent months the volume of Eonia trading has fallen sharply, from the already-low levels observed following the downward path embarked upon in January 2015. The Spanish interbank market recorded a similar performance, with a considerable drop in total volume traded and a much reduced part played by the unsecured segment of the market. In terms of the consolidated balance sheet (see Table 2.1), this translated into a decline of 4.3% in credit institutions' deposits, and of 7.5% in their funding. Accordingly, the net interbank position (credit institutions' funding minus deposits) decreased slightly in terms of total assets, down to 5.5% at June 2015.

Deposits of the private sector rose, thanks to business abroad, narrowing the funding gap somewhat in this sector

Private sector deposits on the consolidated balance sheet were up 5.6% at June 2015 in comparison with a year earlier (see Table 2.1), the reason being the strong growth in this heading in business abroad (up more than 20% at June), while business in Spain fell by 1.5%. As indicated earlier, in the past year exchange rates affected all balance sheet headings in business abroad. At consolidated level, lending to the private sector rose by 4% and deposits of the private sector by 5.6%, triggering, in the past year, a certain narrowing of the funding gap in this sector.

In turn, deposits of households and non-financial corporations in Spain declined...

Analysis of the deposit market of the resident private sector in Spain shows that deposits of households and non-financial corporations declined in the past year: 0.7 year-on-year at June 2015, compared with a year-on-year rate of change a year earlier of 1.9% (see Chart 2.11.A). When securities issued by deposit institutions to households and non-financial corporations are added to deposits, the performance in the past year is similar, although with lower rates of change due to the loss of appeal of these products, which to a certain extent act as a replacement for retail deposits, in comparison with previous years.

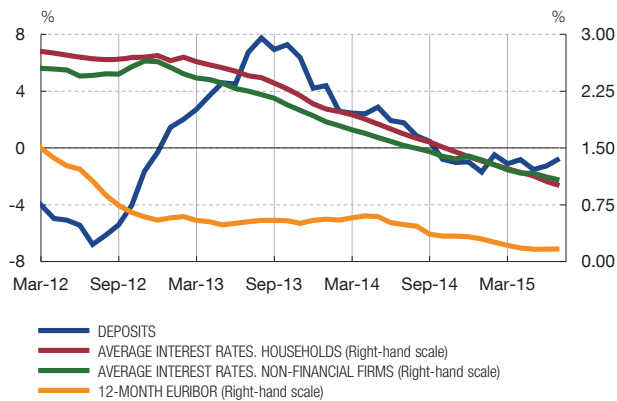
...in response to interest rates

The poorer performance of deposits of households and non-financial corporations in the past year is in response, on the one hand, to interest rates, which in recent years have been at historically low levels, making these savings products marketed by banks less attractive to deposit customers and, on the other, to the relatively low volatility on financial markets. And in consequence, time deposits have shrunk notably in recent years, being replaced in part by sight deposits (see Chart 2.11.B).

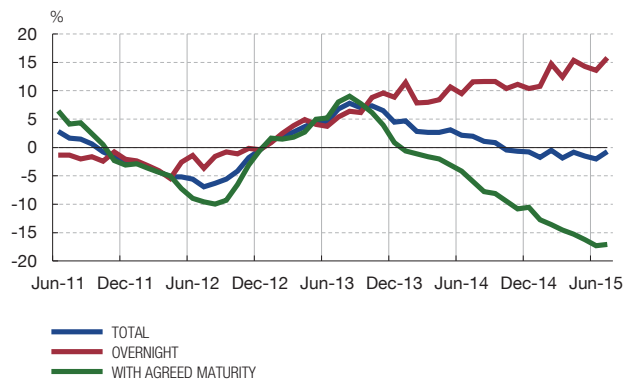
Net assets of investment funds have risen in 2015, mainly on the back of higher net subscriptions

Net assets of investment funds have continued to grow in 2015, maintaining the pattern observed since early 2013. Specifically, at September 2015, the net assets of these funds had increased by almost €26 billion in comparison with a year earlier, a growth rate of 14%. As in previous periods, the main reason for this increase in net assets was the growth in net subscriptions (see Chart 2.11.C).

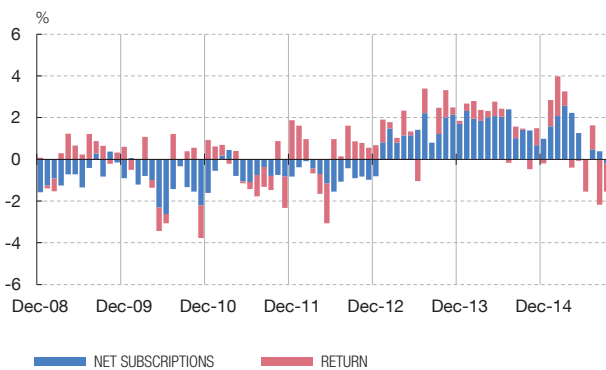
A DEPOSITS FROM HOUSEHOLDS AND NON-FINANCIAL FIRMS, AND AVERAGE INTEREST RATES



B DEPOSITS FROM HOUSEHOLDS AND NON-FINANCIAL FIRMS



C CONTRIBUTION OF RETURN AND OF NET SUBSCRIPTIONS TO CHANGE IN NET ASSET VALUE OF INVESTMENT FUNDS



D LOAN-TO-DEPOSIT RATIO IN RELATIVE TERMS (a)



SOURCES: CNMV and 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.

Higher volatility could reverse the performance of funds and deposits, given their different risk levels

Higher volatility on the financial markets and/or a downward overall correction in the value of these assets (government debt, corporate bonds, shares, etc.), as interest rates or risk premia rise, could reverse the performance in the past year both of (time) deposits and investment funds, given their different risk levels.

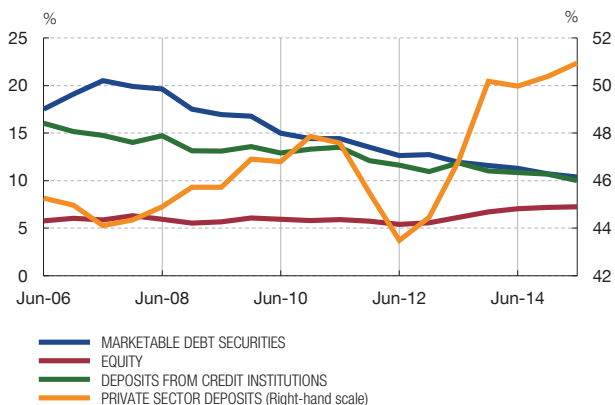
The funding gap has also narrowed in business in Spain

In the past 12 months, on the back of the performance of loans and deposits of households and non-financial corporations in business in Spain, the process of narrowing of deposit institutions' retail funding gap, which commenced in 2007, has continued, albeit more moderately (see Chart 2.11.D), in keeping with the pattern, indicated earlier, observed at consolidated level.

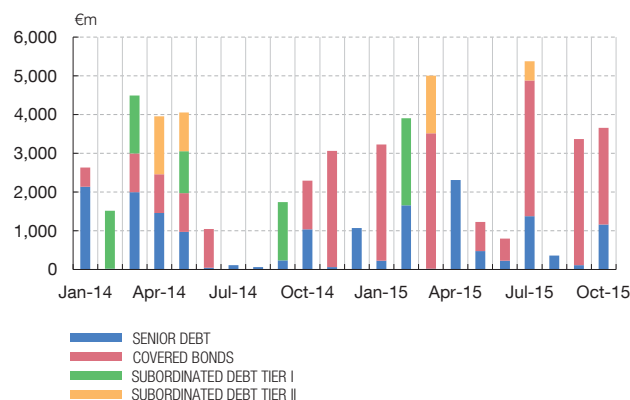
The share of marketable securities on the balance sheet continued to decline, although issues by Spanish banks, especially of covered bonds, increased

Marketable securities declined again in the past year, despite the improvement in the financial market situation. In recent years there has been a structural shift in the liabilities mix of deposit institutions towards funds from the retail sectors and away from wholesale funding (see Chart 2.12.A), although this pattern was interrupted at times at the height of the crisis (2011 to mid-2012). The decline in the share of deposits in that period of tension was largely offset by the increase in ECB funding (see Chart 2.10.A). In any event, Spanish deposit institutions have been particularly active in issuance in 2015 to date, most

A RELATIVE COMPOSITION OF LIABILITIES AND EQUITY AS A PERCENTAGE OF TOTAL ASSETS



B MAIN ISSUES OF SPANISH INSTITUTIONS IN MEDIUM- AND LONG-TERM WHOLESALE MARKETS (a)



SOURCES: Dealogic and Banco de España.

a Senior debt, covered bond and subordinated debt tier I and tier II issues. Retained issues are not included. Latest data: 28 October.

especially in July (see Chart 2.12.B). There has been a notable increase in covered bonds, and not only at the biggest banks as medium-sized institutions have also launched issues in 2015, although senior debt issuance has been more limited year-to-date.

Total deposit institution equity rose, increasing its share of the balance sheet

Total deposit institution equity was up 6.8% at June 2015 compared with a year earlier (see Table 2.1). This strengthened the balance sheet structure in terms of equity, as it grew as a percentage of total assets by 0.3 pp, up to 7.3% at the latest date. Own funds rose by 8.7%, amounting to 6.8% of total assets at June 2015, reflecting the continued solvency improvement at Spanish deposit institutions that began in 2012 (see section 2.3).

Spanish banks have comfortably obtained funding, enhancing their liquidity position and restoring their balance sheet equilibrium

In short, Spanish banks have comfortably obtained funding on the financial markets, improving their liquidity position and restoring their balance sheet equilibrium, and are now well removed from the sharp tensions experienced in 2012. In any event, the risk of heightened volatility and asset price fluctuations signalled in Chapter 1 could prompt a decline in liquidity in certain markets that could rapidly spread to others. In consequence, banks should continue to monitor their liquidity management, not only in the short term but also in view of more structural balance sheet changes.

2.2 Profitability

Spanish institutions recorded income of more than €11 billion in the first half of 2015, up 38.7% on 2014

In the first half of 2015, Spanish deposit institutions overall recorded consolidated income (attributed to the parent institution) of more than €11 billion, which represented an increase of 38.7%, more than €3 billion over the nearly €8 billion recorded in the same period of 2014 (see Table 2.2). This increase in total income resulted in higher profitability, both in terms of the return on assets (ROA) and the return on equity (ROE). Specifically, ROA increased by 16 bp, from 0.47% in June 2014 to 0.63% in June 2015. ROE rose by more than 2 pp, from 7.1% in June 2014 to 9.2% in June of this year, in a context of higher equity at deposit institutions overall, as mentioned earlier when discussing Table 2.1.

The improvement was basically due to foreign business, as various factors exerted downward pressure on the business in Spain

However, it should be mentioned that this improvement in consolidated income was basically due to activity abroad. As explained in detail in Box 2.2, the profitability margins of Spanish institutions at individual level in their domestic business are being pushed down by low interest rates (which could remain low for some time) and by the high volume of non-performing and foreclosed assets. Activity abroad, which in recent years has

CONSOLIDATED INCOME STATEMENT
Deposit institutions

TABLE 2.2

	Jun-15		Jun-14	Jun-15
	€m	% Change Jun-15/Jun-14	% ATA	% ATA
Financial revenue	55,254	-1.5	3.32	3.14
Financial costs	21,064	-16.5	1.50	1.20
Net interest income	34,191	10.8	1.83	1.94
Return from capital instruments	806	-12.3	0.05	0.05
Share of profit or loss of entities accounted for using the equity method	2,175	29.7	0.10	0.12
Net commissions	11,643	4.2	0.66	0.66
Gains and losses on financial assets and liabilities	7,264	3.6	0.42	0.41
Other operating income	-409	.	-0.08	-0.02
Gross income	55,670	10.8	2.98	3.16
Operating expenses	25,686	7.3	1.42	1.46
Net operating income	29,983	13.9	1.56	1.70
Asset impairment losses (specific and general provisions)	12,260	-10.5	0.81	0.70
Provisioning expense (net)	2,619	87.6	0.08	0.15
Operating profit	15,104	34.6	0.67	0.86
Asset impairment losses (assets other than loans and credits)	2,282	0.6	0.13	0.13
Income from disposals (net)	2,149	-37.6	0.20	0.12
Profit before tax	14,972	20.7	0.73	0.85
Net income	12,594	37.1	0.54	0.72
Memorandum item				
Income attributable to the controlling entity	11,020	38.7	0.47	0.63

SOURCE: Banco de España.

evolved more favourably than business in Spain, also faces risks. For example, a slowdown in the emerging economies could increase the NPL ratio in these countries, and lead to their currencies depreciating against the euro, which would reduce their contribution to aggregate income, adversely affecting the profitability of the large Spanish banking groups with a significant presence abroad. The depreciation of the euro against the dollar and the pound sterling would have the opposite effect.

The rise in profits was due to higher net interest income and the decline in provisions

The rise in consolidated profits this year, as compared with the previous year, was due both to higher net interest income and to a decrease in the volume of provisions recorded for impairment of assets on the balance sheet (see Chart 2.13.A). In June 2015, all margins improved (between 10% and 15% year-on-year, see Table 2.2), continuing the growth trend following the low levels reached in 2012 (see Chart 2.13.B). Also, the percentage of operating income absorbed by impairment losses continued to decrease. Operating income has dropped sharply since the peaks recorded in 2012 (see Chart 2.14.A).

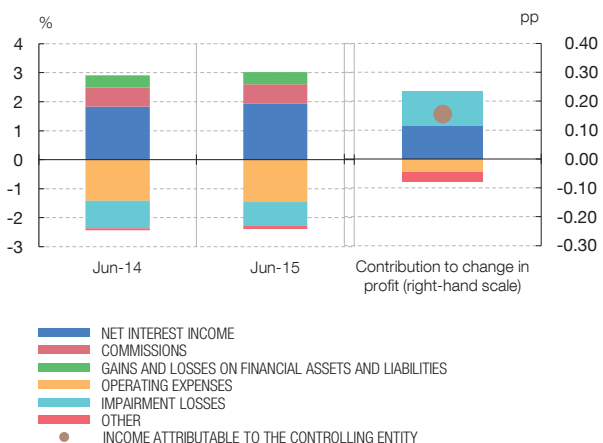
Net interest income increased by 10.8% due to lower financial costs, essentially arising from foreign business

Specific analysis of the main income statement items shows that net interest income in the first half of 2015 rose by 10.8% (€3.3 billion) with respect to the previous year. This was mainly due to the decrease of 16.5% in financial costs, since financial products experienced a much lower decline (1.5%). In the current environment of low interest rates, the improvement in net interest income was due to the fact that the fall in the average return on investment was lower than that in the average cost of liabilities. This increase in net interest income was largely due to foreign business which posted profits that were

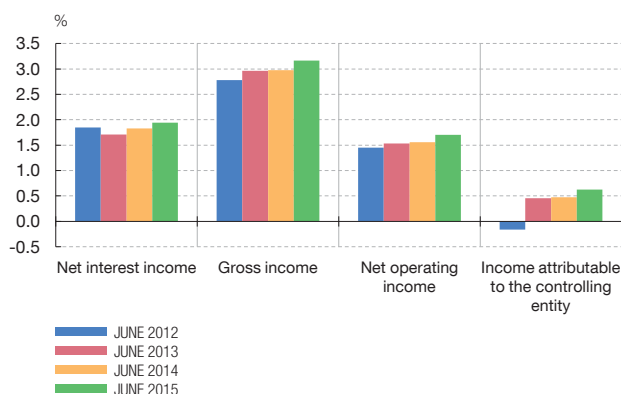
PROFITABILITY
Deposit institutions

CHART 2.13

A CONTRIBUTION OF THE COMPONENTS TO THE CHANGE IN CONSOLIDATED PROFIT AS % OF ATA



B PROFIT MARGINS AS % OF ATA



SOURCE: Banco de España.

15.3% higher in year-on-year terms. As regards activity in Spain, net interest income also increased in the past year, albeit to a lesser extent, as explained in detail in Box 2.2.

Gross income increased to the same extent, due to commissions and gains and losses on financial assets and liabilities

In year-on-year terms, gross income rose by 10.8%, as did net interest income. As with net interest income, this improvement was chiefly due to activity abroad. Looking at the main items of gross income, both net commissions and gains/losses on financial transactions increased by nearly 4%, between the first half of 2014 and the first half of 2015⁴.

Operating expenses increased, but to a lesser extent than gross income...

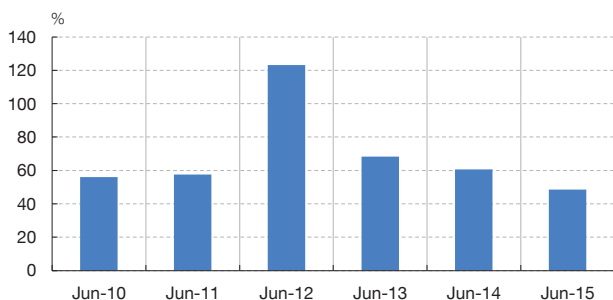
Operating expenses also increased in the past year by 7.3%, but to a lesser extent than gross income, leading to growth of 13.9% in operating income. The increase in operating expenses arose mainly from foreign business which grew by 11.6%, while operating expenses on business in Spain grew only slightly (see Box 2.2). Despite the slight growth in operating expenses on the activity in Spain (partly owing to the costs arising from integration

⁴ Also, as a result of regulatory changes, contributions to the Deposit Guarantee Fund will not be made until the end of the year, which has a positive effect on income in the first half of the year.

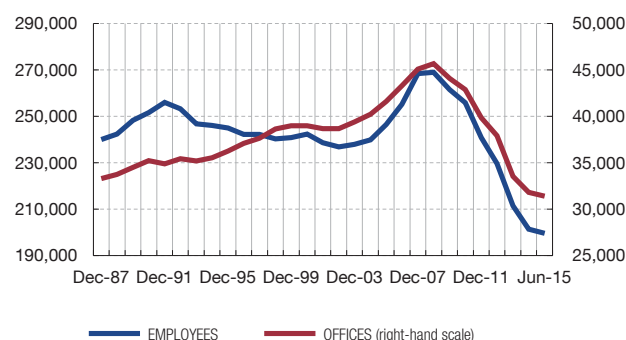
PROFITABILITY
Deposit institutions

CHART 2.14

A PERCENTAGE REDUCTION IN NET OPERATING INCOME DUE TO IMPAIRMENT LOSSES



B NUMBER OF EMPLOYEES AND OFFICES Business in Spain, ID



SOURCE: Banco de España.

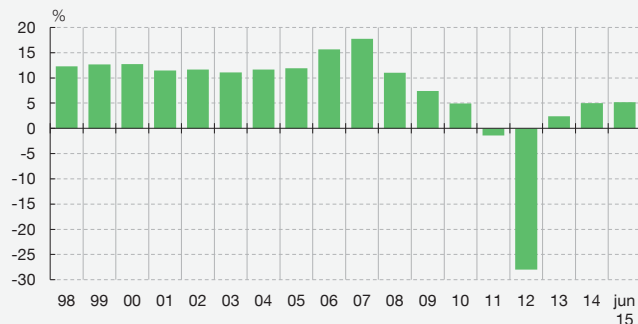
processes which have continued in the first six months of 2015, although less intensely than in previous periods), the capacity adjustment process continued in recent months, through cut-backs in offices and employees (see Chart 2.14.B). This chart shows the scale of cut-backs in branches and staff in the Spanish banking sector as a result of the crisis. Currently, the number of branches and employees is lower than it was at the beginning of the process of deregulation at the end of the 1980s. Naturally, in part, this situation also reflects the increase in productivity arising from the use of new technologies in the banking sector.

This box offers a detailed analysis of the income statements of Spanish banks in their business in Spain. Although ROE for business in Spain has turned positive again, at around 5%, the present levels are still very distant from the usual levels of the mid-2000s or the late-1990s (see Panel A) and are below the cost of capital¹. This poses a challenge for Spanish banks in respect of their present business model.

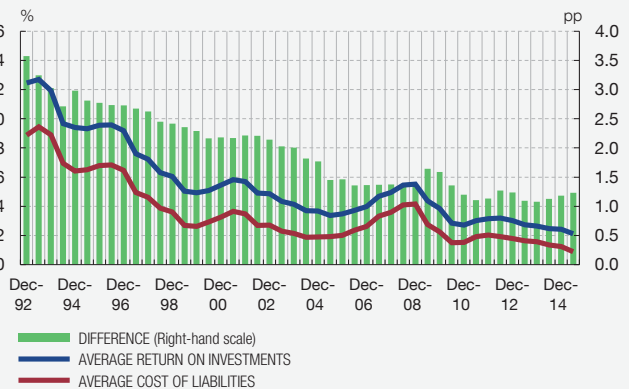
The main pressures on income statements in business in Spain are the prevailing low interest rates in the euro area (which could

¹ The ECB estimates the current cost of capital at 8%-10% for most banks in the euro area; see Box 5 of the Financial Stability Review, May 2015. https://www.ecb.europa.eu/pub/pdf/other/financialstabilityreview201505_en.pdf?3cd887eb74f562fc8db70554df5b01ca.

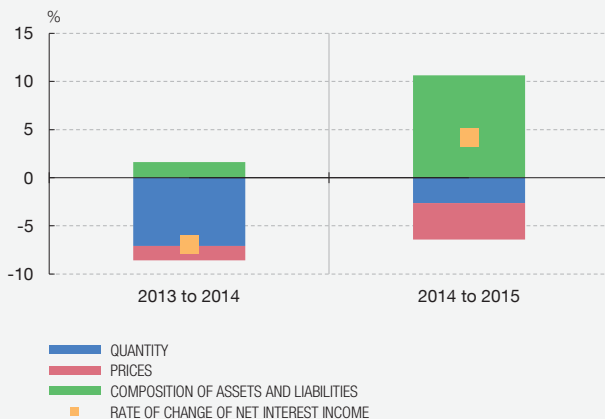
A RETURN ON EQUITY
Business in Spain, ID



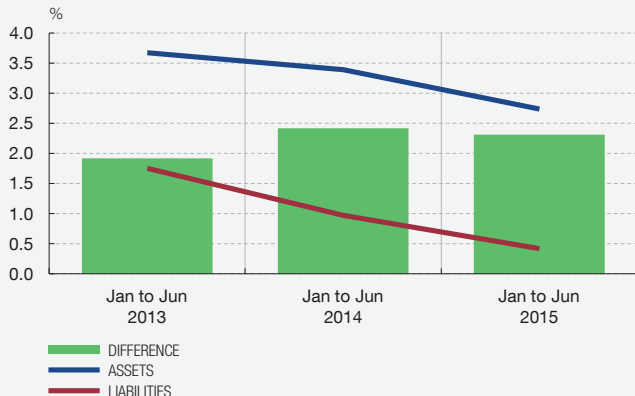
B DIFFERENCE BETWEEN AVERAGE RETURN ON INVESTMENT AND AVERAGE COST OF LIABILITIES
Business in Spain, ID



C PERCENTAGE OF THE CHANGE IN NET INTEREST INCOME VARIATION EXPLAINED BY EACH FACTOR
Business in Spain, ID



D MARGINAL INTEREST RATES ON ASSETS AND LIABILITIES (a)
Business in Spain, 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 those of liabilities include fixed-term deposits and repos, among others.

INDIVIDUAL INCOME STATEMENT. BUSINESS IN SPAIN
DEPOSIT INSTITUTIONS (a)

TABLE A

	Jun-15		Jun-14	Jun-15
	€m	% Change Jun-15/Jun-14	% ATA	% ATA
Financial revenue	21,850	-17.1	2.10	1.73
Financial costs	9,114	-35.6	1.13	0.72
Net interest income	12,736	4.2	0.97	1.01
Net commissions	5,329	1.1	0.42	0.42
Gains and losses on financial assets and liabilities	4,727	-20.8	0.48	0.38
Gross income	27,248	-4.3	2.27	2.16
Operating expenses	12,408	1.0	0.98	0.98
Net operating income	14,840	-8.3	1.29	1.18
Asset impairment losses (specific and general provisions)	8,393	-17.2	0.81	0.67
Net income	5,748	3.2	0.44	0.46

SOURCE: Banco de España.

a This income statement is referred to institutions obliged to report own funds.

continue for some time), the still-low level of activity and the significant volume of non-productive assets (non-performing loans and foreclosed assets) on banks' balance sheets. Pressure on income statements owing to the low interest rate scenario, in response to a euro area inflation rate that is below the ECB's target rate, affects not only Spanish banks but also most European banks, as do the other two factors, although with varying intensity by country. In Spain, as Panel B shows, interest rates on assets and liabilities in the banking sector are at historically low levels.

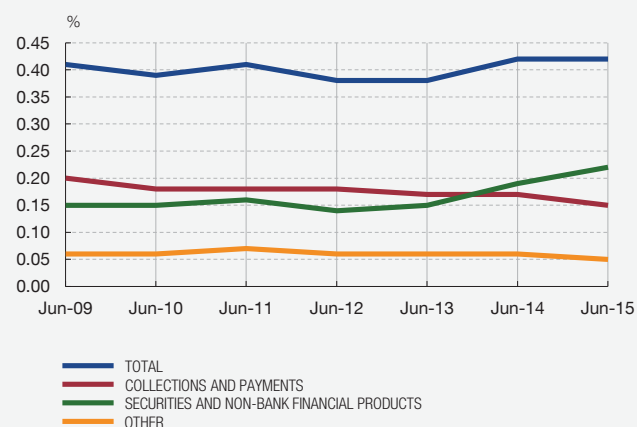
To describe the latest income performance, analysis of the various elements that make up the income statement is appropriate. Net interest income on business in Spain rose by 4.2% in the past year

(see Table A), as a result of the decline in financial costs (35.6%) that outpaced the drop in financial revenue (17.1%).

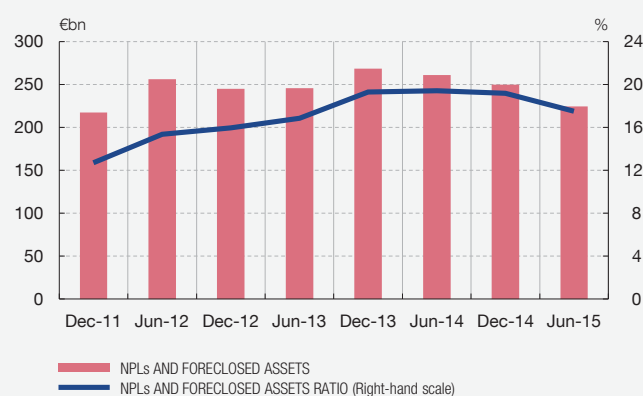
However, as Panel C shows, in the past year changes in the composition of balance sheets were the main reason for the growth in net interest income. Notably the low rate of remuneration of time deposits has meant that they are being replaced by sight deposits (see Chart 2.11.B) which are less costly for banks.

The price effect on net interest income as a result of the average interest rates on assets and liabilities has been negative, owing to the already very low average remuneration of liabilities, where there is increasingly less room for manoeuvre, and to a lesser extent to the fiercer competition on the asset side. Thus, in recent months,

E NET COMMISSIONS AND THEIR MAIN COMPONENTS AS % OF ATA



SOURCE: Banco de España.

F RESIDENT PRIVATE SECTOR NPLs AND FORECLOSED ASSETS, AND THE NPL AND FORECLOSED ASSETS RATIO
Business in Spain

the decline in marginal rates on new asset transactions has been somewhat more marked than on new liabilities (see Panel D).

The sustainability of net interest income when the interest rate differential is so narrow largely depends on there being a sufficiently high level of activity. At present, this is not the case. In fact the impact of the activity level (the volume effect) was also negative in the past year, albeit smaller in absolute terms than in the previous year.

Gross income from business in Spain fell by 4.3% in year-on-year terms, as a result of the sharp decline in gains on financial transactions (20.8%) and the decrease in dividends received on investments in capital instruments. Gains from the sale of financial assets fell compared with the first half of 2014 and 2013, although they remain higher than those recorded in previous years.

Net commissions rose slightly in the past year (1.1%), although not sufficiently to offset the sharp fall in gains on financial transactions, hence the decline in gross income. In any event, net commissions were affected by the contrasting performance of two elements: on the one hand, commissions from the sale of non-bank financial products and from securities services, which rose in keeping with the higher demand for these products given the low interest rate environment; and on the other, commissions from collection and payment services, which are more closely linked to bank activity and which declined (see Panel E).

Operating expenses in business in Spain increased somewhat in year-on-year terms (1%); however, as indicated in the body of the Report, they remain contained as a result of the reduction in both branch and staff numbers (see Chart 2.14.B), a process that is expected to continue for some time yet and to permit further efficiency gains. Nevertheless, efficiency gains from cost savings are constrained by the need to contain operating risks and, in particular, IT risks.

Accordingly, in certain cases, it may be appropriate to consider possible mergers or acquisitions in order to achieve the efficiency gains suggested on a sustained basis.

Asset impairment losses have continued to decline (17.2% year-on-year) and, as a result, net income from business in Spain has finally improved slightly, up 3.2% (€175 million) at June 2015 on a year earlier. Nevertheless, despite this drop in impairment losses, and as already indicated, the high volume of non-performing exposure on banks' balance sheets puts further pressure on income statements, since it makes no positive contribution, but it consumes resources and entails provisioning costs (loss of value) and maintenance costs. The high volume of non-productive assets, comprising NPLs and foreclosed assets, which causes this increased pressure on income statements, along with the ratio of NPLs and foreclosed assets as a proportion of credit to the resident private sector, are depicted in Panel F.

... enhancing institutions' efficiency ratio

As gross income increased at a higher rate than operating expenses, the efficiency ratio (operating expenses divided by gross income) improved, standing at 46.1% in June 2015, 1.5 pp lower compared with the same period in 2014. However, the less favourable performance of gross income from business in Spain has led to a decline in the efficiency ratio of business in Spain in the last twelve months.

Asset impairment losses continued the downward trend which had begun in 2012.

Asset impairment losses (specific and general provisions) continued to decline (see Chart 2.14.A) from the peaks recorded in 2012 (the year Royal Decree-Laws 2/2012 and 18/2012 were applied), partly as a result of the decrease in the NPL ratio mentioned in section 2.1.1. In year-on-year terms, asset impairment losses fell by 10.5% in June 2015 (nearly €1.5 billion). This decline was due to business in Spain, since for foreign business, financial asset impairment losses increased in the past year. In fact, the significant decline in the level of these provisions in Spain contributed very favourably to ensuring that income from business in Spain also improved with respect to last year. Losses arising from the impairment of assets other than loans and credits (including provisions to cover the decline in value of foreclosed assets) remained relatively constant (with growth of 0.6%) as compared with the previous year.

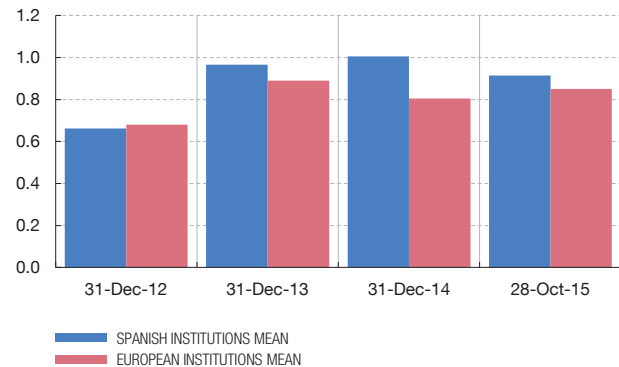
In short, in the first half of 2015, total consolidated income of Spanish deposit institutions continued...

In short, in the first half of 2015, total consolidated income of Spanish deposit institutions continued the recovery initiated in 2013. All income categories, including interest income, improved by more than 10% on the previous year, owing to the fact that the average cost of liabilities decreased more than the average return on assets. Thus, in

A STOCK MARKET PERFORMANCE BETWEEN 1 JANUARY AND 28 OCTOBER 2015



B PRICE-TO-BOOK-VALUE RATIO



SOURCE: Datastream.

a The average of Spanish banks is calculated by taking all the Spanish banks listed at each date, while the average of European banks is calculated by taking all the main European banks.

...the recovery initiated in 2013, although profitability continues to be a risk factor.

line with the trend of recent quarters, the more favourable behaviour of NPLs meant lower asset impairment provisions, which, in turn, contributed to boosting income. However, despite this improvement on the results of previous years, the current profits are at historically low levels, since the low interest rate environment, low activity and still-high levels of non-performing assets put pressure on the income statements of the institutions in Spain.

The stock market behaviour of Spanish institutions has been less favourable than that of its European peers in recent months

In recent months, the stock market behaviour of listed Spanish institutions has been less favourable than that of its European peers (see Chart 2.15.A). The ratio of market value to book value for Spanish banks, although still slightly higher than that of the main European banks declined with respect to these banks over the current year (see Chart 2.15.B).

2.3 Solvency

At June 2015 the top-quality capital (CET1) ratio stood at 12.4%, having risen significantly,...

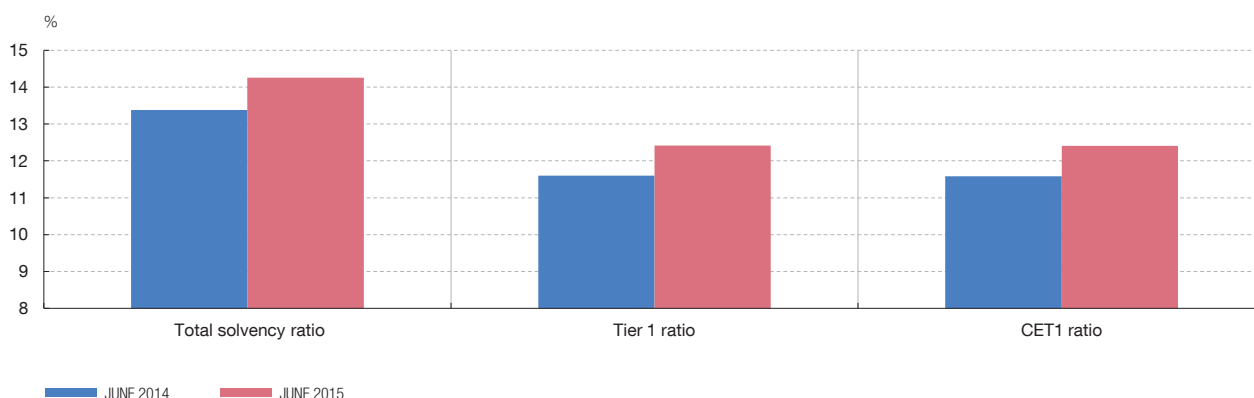
At June 2015 the top-quality capital ratio, common equity tier 1 (CET1), of Spanish deposit institutions stood at 12.4%, more than 80 bp higher than at June 2014 (see Chart 2.16). The capital increases made in late 2014 and early 2015 at Spain's two largest banks are the main reason for this growth. Thus, aggregate CET1 is comfortably above the regulatory minimum of 4.5%⁵.

... while the total capital ratio stood at 14.3% and the tier 1 capital ratio at 12.4%, both above their respective regulatory minimum levels

The total capital ratio stood at 14.3% at June 2015, posting a similar increase to the CET1 ratio in the past year. In turn, the tier 1 capital ratio (which adds additional tier 1 capital to CET1), stood at virtually the same level as the CET1 ratio (12.4%) at June 2015, owing to the effect of gradual transitional adjustments, particularly in relation to deductions⁶. Both capital ratios are comfortably above the respective regulatory minimum levels of 8% and

5 The capital conservation buffer will be phased in from 1 January 2016. This will raise the capital requirements by 0.625% each year, up to the definitive CET1 level of 7% in 2019. In addition, also from 2016, all institutions, including those directly supervised by the SSM (more than 90% of the Spanish banking system), will have to comply with the minimum capital requirement under Pillar 2 as well as Pillar 1, as a result of supervisory discretion, and these requirements may overlap with some of the existing capital buffers.

6 The ratios take into account the transitional adjustments that facilitate the gradual implementation of Basel III. The implementation timetable specifies generally that, in 2015, only 40% of total deductions are to be subtracted from common equity, with the remaining 60% being deducted from additional tier 1 capital. In quantitative terms, the main transitional adjustments relate to deductions of intangible assets, and, secondly, to deductions of deferred tax assets based on future income.



SOURCE: Banco de España.

6%. In absolute terms, CET1 rose by more than €17 billion in the past year, reaching almost €210 billion at June 2015. In turn, the total capital volume rose by slightly more (€19 billion) to €240 billion at June 2015 (see Chart 2.17.A).

The bulk of own funds is CET1

Common equity tier 1 accounts for the bulk of own funds (87%); the remainder are mainly tier 2 capital (see Chart 2.17.B). This breakdown of own funds has been practically constant throughout the past year.

Capital and reserves are the two main components of CET1

Regarding the composition of common equity tier 1, insofar as eligible elements are concerned, capital instruments are the main component (47%), followed in quantitative terms by reserves (30%). Accordingly, these two elements account for more than 75% of eligible elements of CET1; transitional adjustments (17%) and minority interests and other (6%) complete the list. There was no material change in the relative significance of the eligible elements of CET1 in the past year, although the proportion of capital instruments declined slightly while that of reserves and transitional adjustments rose. Deductions decreased in the past year, but the bulk (60%) continued to be deductions from goodwill and other intangible assets. Deductions from deferred tax assets dropped to 16%, falling below other deductions (24%) in quantitative terms. Chart 2.17.C depicts the CET1 structure in terms of risk-weighted assets (RWAs).

Risk-weighted assets rose by 1.8%, but fell as a percentage of total assets to 46%

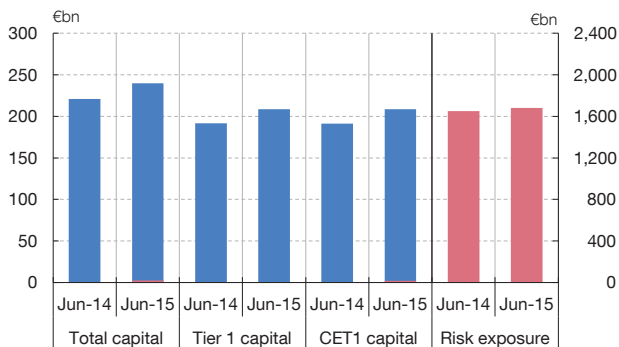
Lastly, risk-weighted assets (RWAs), the denominator of the capital ratios, amounted to more than €1,681 billion at June 2015, an increase of 1.8% on a year earlier. Nevertheless, given that the total assets of Spain's deposit institutions rose at a faster pace, as a percentage of total assets RWAs fell by almost 1 pp to 46%. The make-up of RWAs changed very little in the past year: the main component is credit and counterparty risk (86%)⁷, followed by operational risk (9%) and position, foreign exchange and commodity risks (4%), while all other risks amount to less than 1% of RWAs (see Chart 2.17.D). In addition, there was no material change in the volume of exposures subject to the standardised approach or the internal ratings based (IRB) approach, or in the relative density (the ratio between risk-weighted assets and total exposure) of either approach by portfolio.

⁷ Credit and counterparty risk is that arising from credit exposures, equity exposures and securitisation positions and includes that calculated using RWAs obtained by both the standardised approach and the IRB approach.

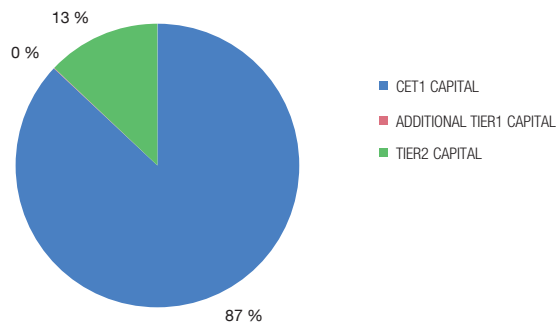
BREAKDOWN OF OWN FUNDS AND RISK-WEIGHTED ASSETS
Deposit institutions. June 2015

CHART 2.17

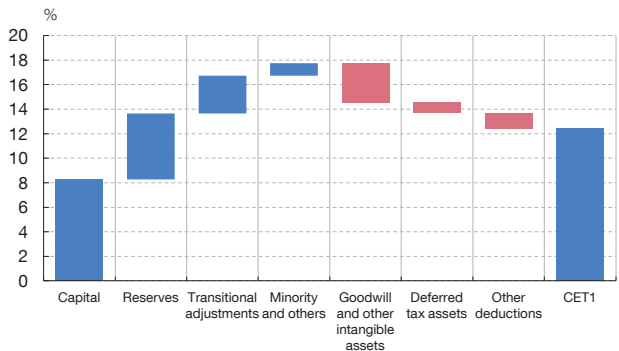
A LEVELS OF CAPITAL AND RISK EXPOSURE (right-hand scale)



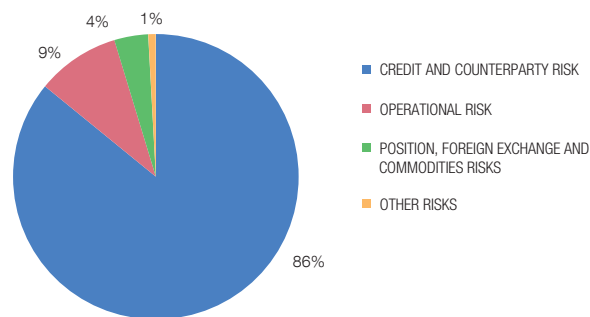
B BREAKDOWN OF OWN FUNDS



C BREAKDOWN OF CET1 RATIO AS % OF RWA



D BREAKDOWN OF RISK-WEIGHTED ASSETS



SOURCE: Banco de España.

In short, Spain's banks continued to reinforce their solvency so as to be able to face potential risks

All the foregoing shows that Spanish banks continued to reinforce their solvency so as to be able to face potential risks such as those signalled throughout this Report. This is reflected not only in the enhanced solvency ratios (according to any definition), but also in the absolute increase in own funds, accompanied by a slight increase in RWAs.

3 OTHER MATTERS. DEFERRED TAX ASSETS

This chapter describes the treatment of deferred tax assets (DTAs) under existing tax and bank solvency law, and also outlines the recent changes to this law.

Deferred tax assets are a right to pay less tax in future. There are two types: temporary differences generated by differences between tax and accounting criteria, and ...

DTAs represent a right to pay less tax in relation to future tax declarations. There are two types of DTA: those arising from temporary differences and credits for tax losses. A DTA arising from temporary differences arises as a consequence of the different criteria used by the accounting and fiscal frameworks when determining the precise moment at which a particular expense may be recognised. For example, there are certain provisions that under the accounting framework are considered expenses at the time they are incurred, but which under the tax framework are not accepted as such until a later date. In this case, the profit obtained by the firm calculated under the accounting framework will be lower than that calculated under the tax framework, the latter being the one to which the tax rate is applied to determine the tax payable.

That difference between the tax that would have to be paid on accounting profit and the tax that is actually paid is what is recorded as a DTA arising from temporary differences. When on a future date the tax framework considers the expense admissible, the opposite effect will occur: the accounting profit will be greater than the taxable profit, and the DTA arising from temporary differences will be derecognised.

... credits for tax losses

The other type of DTA is credits for tax losses: firms may offset against the taxable profits obtained in one year the tax losses recorded in previous years, before determining the amount of tax payable. Until tax losses have been offset a DTA in respect of credit for tax losses is recorded in the balance sheet. When in a future year the firm obtains profits and offsets the losses, the DTA will be derecognised.

The volume of DTAs exceeded €68 billion in December 2014, because ...

Groups of significant credit institutions, those that are directly supervised by the SSM, had €68,464 million of deferred tax assets net of tax liabilities as at 31 December 2014. These significant amounts of DTAs are largely explained by the restrictive nature of the accounting and tax regulations applicable in Spain:

...Spanish tax regulations are very restrictive as regards the admissibility of tax expenses, and...

i) Tax law does not recognise various items that are recorded as expenses in the accounting statements as tax deductible expenses. In the case of credit institutions, typical examples are the general provisions they are obliged to set aside, which are mostly considered not to be tax deductible expenses, and provisions for collateralised contingencies.

...Spanish accounting regulations are very demanding, for instance in the case of provisions

ii) The restrictive nature of tax law is reinforced by its interaction with accounting law, which is also very demanding. This interaction is especially noteworthy in the case of provisions. As a consequence of the accounting regulations applicable to the banking sector, Spanish credit institutions normally set aside a very high volume of provisions in comparison with the firms of other sectors and the institutions of other countries. These requirements were significantly increased by the extraordinary provisions for the real estate sector that were established in order to rebuild credit institutions' balance sheets (Royal Decree Laws 2/2012 and 18/2012).

The combination of higher provisioning requirements with a lower acceptance of such provisions as tax expenses largely explains the existence of significant volumes of DTAs on the balance sheets of Spanish credit institutions.

To ensure the recording in the accounts of tax credits, mechanisms are established to ensure that DTAs arising from temporary differences are used

In order to ensure these claims are recoverable against the tax authorities, thereby strengthening the equity of Spanish companies that pay corporate income tax, irrespective of their size, legal form, characteristics, activity or the economic sector in which they operate, a change to the Corporate Income Tax Law¹ was introduced by Royal Decree Law 14/2013. This reform established mechanisms to guarantee the recovery of the amount of certain DTAs arising from temporary differences (DTAs covered by this guarantee are normally called “deferred tax credits” (DTCs)). Briefly, the main aspects of this guarantee are:

- i) It allows, subject to the limits described below, the amounts to which the new rule refers to be set off against other tax debts, or else to be refunded.
- ii) This mechanism does not apply to all DTAs, only those arising from temporary differences. Moreover, it only covers temporary differences generated by two items: provisions for loan losses or foreclosed assets, or pension commitment expenses.
- iii) Not only is the scope of the mechanism restrictive, but also the cases in which it would be activated: in the event of insolvency or winding up of the company, it would be fully activated, and, if there are accounting losses, it would be limited to the percentage of the company’s own funds that the losses represent. In addition, if the DTCs are not reversed within 18 years, they may be exchanged for government securities.

Both the activation conditions and the scope of the mechanism are restrictive ...

...so that the probability that DTCs will have a significant impact on government tax revenues is very low

As regards their impact on credit institutions, any reasonable estimate leads to the conclusion that the probability of occurrence of any of the situations that would trigger a refund of DTCs by the tax authorities with a significant impact on government tax revenues is very low. This conclusion is based on the restrictive nature of the mechanism as regards the temporary differences covered and events that would activate it, the latter being very unlikely to occur, as historical experience shows. Consequently, it will continue to be normal for DTCs to be recovered naturally, by being claimed as a tax expense in the year in which they become deductible.

The CRR establishes that the deferred tax assets of banks that are dependent on future profitability are deducted from CET1

Although the foreseeable impact of the refunding of DTCs by the tax authorities to credit institutions is very limited, there is a significant effect insofar as the determination of regulatory capital is concerned. The new European solvency legislation (CRR), which came into force in January 2014, introduced a new requirement for deferred tax assets of banks that are dependent on future profitability to be deducted from regulatory capital (specifically the highest quality capital, CET1). This change in the solvency legislation entailed a significant change in the relevance of the DTAs on Spanish credit institutions’ balance sheets when their solvency is assessed.

The tax legislation that introduced mechanisms...

The tax legislation that introduced mechanisms for recovering certain DTAs allowed the potential impact of DTAs on capital ratios to be mitigated. As mentioned above, the CRR

¹ The previous law on corporate income tax has recently been replaced by Law 27/2014, which includes the mechanisms that guarantee the ability to recover certain DTAs, in similar terms to the previous law.

...for the recovery of certain DTAs allowed their potential impact on capital ratios to be mitigated

requires that DTAs that are dependent on future profitability be deducted from capital. However, for DTCs to be recoverable it is no longer necessary for the credit institution to earn profits in future. For this reason, the CRR does not require DTCs to be deducted when the capital ratio is calculated.

European state aid legislation and amendment of Spanish tax legislation

Under the Treaty on the Functioning of the European Union, aid granted by a Member State or through State resources that distorts competition by favouring certain companies or the production of certain goods shall be incompatible with the single market insofar as it affects trade between Member States.

The European Commission has issued requests for information, as a result of which tax legislation has been amended to ensure its compatibility with EU law on state aid

The European Commission has issued requests for information to the Spanish government, as it has to the governments of other EU countries with similar laws, in relation to those DTAs that do not reduce banks' capital. As a result of these requests, it was agreed that the Corporate Income Tax Law would be amended, by means of the 2016 State Budget Law, to ensure that the fiscal rules regarding DTCs are compatible with European law on state aid.

Two types of DTC are distinguished:

The planned amendment is based on a distinction drawn between the different types of DTCs, according to whether they are generated in periods in which tax has been paid:

DTCs that have triggered higher tax payments (type 1) and ...

i) Type 1: DTCs that have triggered higher tax payments in the period (the temporary difference arises as a consequence of accounting expenses that are not accepted as tax expenses, which implies a higher tax base and a higher tax payment).

... all other DTCs (type 2), where three changes are made to the regulations

ii) Type 2: all other DTCs where, although the temporary difference means that taxable profit is higher than accounting profit, the institution records a negative taxable income (tax losses), or where, although a positive taxable income is recorded, it is not sufficient to cover all the DTCs generated, so no tax is actually paid.

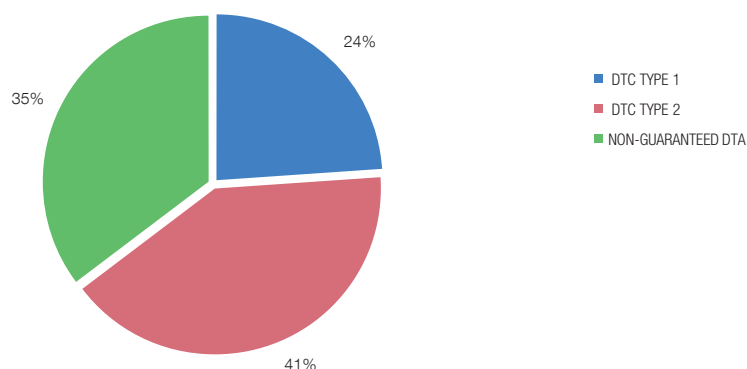
This distinction draws from the idea that in the case of type 1 DTCs, the institution has prepaid tax, having been unable to take a tax credit against part of the accounting expense, so these DTCs simply guarantee that firms will be able to recover tax paid in excess.

Accordingly, the change to tax legislation focuses on type 2 DTCs, specifically on three aspects, leaving the essential characteristics of the arrangements unaltered (there is no change to the sources of the temporary differences that may be guaranteed or to the events that would trigger that guarantee).

First, from 2016, guarantees will only be provided to new DTCs if they are type 1

The first change only affects temporary differences susceptible to conversion into DTCs that are generated from 2016. The new tax regulations establish that the guarantee arrangements will only cover temporary differences arising from provisions for loan losses or foreclosed assets, or pension commitment expenses, up to the limit of the tax actually paid in that financial year. This means that from 2016, guarantees will only be provided to new DTCs if they are type 1 (it will not be possible to generate type 2 DTCs).

If the net tax payable in a financial year is higher than the temporary differences that may generate a DTC in that year, the excess may be used to consider as type 1 DTCs temporary



SOURCE: Banco de España.

a DTA: deferred tax assets. DTC: guaranteed DTA.

differences arising from provisions for loan losses or foreclosed assets, or pension commitment expenses from previous financial years (including from the stock at 31 December 2015) or from the following two financial years (which in the calculation of the respective year were classed as type 2 DTCs).

Second, an annual consideration of 1.5% will be paid for type 2 DTCs existing at end-2015

The second change introduces a way to deal with the existing volume of DTCs at 31 December 2015. If an institution decides to keep the guarantee, it will cover the full amount of DTCs (irrespective of whether they are type 1 or type 2), but in exchange the institution will have to pay an annual consideration of 1.5% on the part of that amount that relates to type 2 DTCs.

The amount on which the consideration is payable will initially be calculated as the difference between the DTCs generated in the tax periods 2008 to 2015 and the aggregate sum of the net tax payable in that period. In future years that amount may be reduced, as a consequence of reversal of the constituent temporary differences or by operation of the arrangement described above. The first tax period for which the annual consideration will be payable is 2016.

Third, the guarantee arrangement will no longer be automatic but voluntary

Lastly, the third change, made to counterbalance the introduction of a new consideration, is that the guarantee arrangement will no longer be automatic but voluntary. Institutions will have to either accept the guarantee (and pay the consideration) or reject it; if they accept the guarantee it will remain indefinitely until such time as there are no DTC balances.

Institutions will pay a consideration of 1.5% for the guarantee

Based on data at 31 December 2014, the main Spanish groups of credit institutions (those supervised by the SSM) had deferred tax assets net of tax liabilities amounting to €68,464 million, of which €44,287 million were DTCs (of which €41,468 million generated in Spain). Of the latter it is estimated that €27,924 million are type 2 DTCs (see Chart 3.1); charging a consideration of 1.5% on those DTCs would entail an outlay of €419 million by institutions.

The consideration will decrease as type 2 DTCs are gradually eliminated

It should be noted that the consideration will gradually decrease, since it is calculated on type 2 DTCs that will gradually be eliminated, as the new tax legislation precludes the creation of new type 2 DTCs. As the volume of type 2 DTCs remaining declines, so will the consideration payable.

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- 1 The publications in this section distributed by the Banco de España [all of them, except those marked (*) and (**), which are distributed by Alianza Editorial and Macmillan (London)] have been removed from the catalogue.
- 2 Moreover, it is updated daily in the Statistics section.
- 3 A quarterly update of the tables of this publication is also disseminated on the Internet.
- 4 Available only on the Banco de España website until it is included in the publication *Circulares del Banco de España. Recopilación*.

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