FINANCIAL STABILITY REPORT

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BANCO DE ESPAÑA

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ABBREVIATIONS

€	Euro
AIAF	Asociación de Intermediarios de Activos Financieros (Association of Securities Dealers)
ATA	Average total assets
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
bn	Billions
bp	Basis points
CBE	Banco de España Circular
CBSO	Banco de España Central Balance Sheet Data Office
CCR	Banco de España Central Credit Register
CDS	Credit default swaps
CIs	Credit institutions
DIs	Deposit institutions
ECB	European Central Bank
EMBI	Emerging markets bond index
EMU	Economic and Monetary Union
EU	European Union
FAHT	Financial Assets Held for Trading
FSA	Financial Service Authority
FSAP	Financial System Assessment Program
FSR	Financial Stability Report
GDI	Gross disposable income
GDP	Gross domestic product
GVA	Gross value added
GVAmp	Gross value added at market prices
IAS	Internacional Accounting Standards
ICO	Instituto Oficial de Crédito (Official Credit Institute)
ID	Data obtained from individual financial statements
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LGD	Loss given default
m	Millions
MEFF	Mercado Español de Futuros y Opciones (Spanish Financial Futures and Options Market)
MTS	Market for Treasury Securities
NPISH	Non-profit institutions serving households
PD	Probability of default
PER	Price Earnings Ratio
pp	Percentage points
ROA	Return on assets
ROE	Return on equity
RWA	Risk-weighted assets
SCIs	Specialised credit institutions
SENAF	Sistema Electrónico de Negociación de Activos Financieros (Electronic Financial Asset Trading System)
SMEs	Small and medium-sized enterprises
SPV	Special-purpose vehicle
TA	Total assets
VaR	Value at risk

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Introduction

The analysis of risk, profitability and solvency in this Financial Stability Report (FSR) must be viewed with some caution, because on 1 January 2005 the new accounting Circular of the Banco de España (CBE 4/2004) came into force. This Circular, which replaces CBE 4/1991, adapts the Spanish banking system to the International Financial Reporting Standards (IFRS) adopted in January 2005 by the European Union, the application of which is compulsory for the preparation of the consolidated financial statements of companies with securities quoted on a regulated EU market. CBE 4/2004, in addition to recognising the special features of Spanish credit institutions, enables these institutions, through application of the Circular, to comply with the IFRS adopted by the EU. The new Circular is applicable to all credit institutions, and both to their individual and consolidated statements. Although it came into force in January 2005, the first figures to be submitted under the new accounting principles are those for June 2005. Moreover, for the purposes of comparison and of assessing the impact of the accounting change, information for January, June and December of 2004, prepared in accordance with the new Circular, is to be filed by credit institutions.

CBE 4/2004 appreciably changes the accounting approach in place before it came into force, and it increases the responsibility of institutions' managers in financial reporting. The changes introduced affect not only valuation criteria which, inter alia, give greater importance to estimated present value (e.g. through the introduction of fair value), but also consolidation (public financial statements under IFRS will now be required of insurance companies and other non-financial corporations). Also, the new rules take into account the impairment of financial assets through valuation adjustments deducted from the asset value, which represents a change from its previous consideration on the liability side as bad debt provisions or the like.

Furthermore, there have been additional changes in the definition of doubtful assets, in the possibility of derecognising securitised assets depending on the degree of transfer of risks and rewards in that process, in the measurement of goodwill, in accounting for loan origination fees and in the classification of holdings in companies, with their varying effects on the balance sheet and income statement.

The aforementioned changes, which are not exhaustive but simply a sample, mean that caution must be exercised in comparing the 2005 data (which conform to the new Circular) with those of prior dates, since the information on 2004 balance sheets and income statements restated in accordance with the new accounting criteria is still not fully available.

The significant changes introduced by CBE 4/2004 have led the Banco de España to amend CBE 5/1993 implementing the regulations on own funds and consolidated supervision of credit institutions. This amendment gave rise to CBE 3/2005, which determines the instruments eligible as own funds and sets out adjustments to be applied to accounting equity to adapt it to the definition of regulatory capital, but which avoids any change in the level of requirements, either because the new risk exposures included in the accounts are not to be subject to additional capital requirements or because the new rules increase or decrease their book amount. CBE 3/2005 seeks not to alter the substance or the definition of eligible capital or the calculation basis for requirements.

Taking into account all the above caveats, the activity of Spanish deposit institutions was, in line with previous Financial Stability Reports, considerably buoyant in June 2005, compared

with the same period a year earlier, particularly in financing granted to the private sector. Against a favourable macroeconomic background, institutions continued to show high levels of profitability, although their solvency ratios were slightly lower. However, the solvency of Spanish deposit institutions as a whole was substantially above the minimum requirements. The position of institutions is strengthened by their ongoing cost-cutting efforts.

As regards the caution required in any comparison with 2004 data, it is not only the accounting changes that have to be borne in mind. In December 2004 a large UK institution was acquired by a Spanish institution. This means that a substantial part of the growth of, for example, certain asset headings or risk-weighted assets may be due to this acquisition. Likewise, the effects of this acquisition are reflected in the June 2005 income statement, but not in that for the same period of 2004. Finally, the solvency ratios were also temporarily affected due to the size of the institution involved. All these factors were duly reflected in detail in the previous FSR.

Banking risks

The activity of deposit institutions grew strongly, favoured by the cyclical position of the Spanish economy which, unlike that of the euro area as a whole, was most buoyant. The increase in activity was largely due to the performance of credit to the resident private sector in business in Spain, which continued to accelerate in the first half of 2005.

The performance of credit to the resident private sector is related to lending to the real estate sector in the broad sense of the term, i.e. both to households for house purchase and to construction companies and, basically, property developers. These developments confirm the difference in behaviour over the last few years, as a result of which the relative weight of property-related credit in the credit portfolios of Spanish deposit institutions is rising. Hence, for the time being, there are no clear signs of a turnaround in the behaviour of deposit institutions' exposure to this sector.

By contrast, certain worrying developments are indeed appearing in the market for mortgage-related banking products. At issue here are long-term mortgage products with provision for flexible adjustment of the repayment period or even long grace periods and the option to delay payment of a significant portion of the loan principal until maturity. The greater diversity of credit products could contribute to increased efficiency in the allocation of funds and make for improved distribution of risk. However, in the short and medium run, the presence of asymmetric information translates into high learning costs for customers and institutions. Thus, improved access to credit should be based on appropriate risk monitoring and control by credit institutions and on a sound knowledge by bank customers of the risk involved in the various products. Otherwise, the diversity of products may ultimately affect financial stability and cancel out the potential gains accruing to the public from a more complete credit market.

A consequence of the favourable performance of corporate profits has been the high profitability ratios reported by non-financial corporations. The continual increases in debt have led to a rise in aggregate debt ratios and to a slightly higher interest burden. However, the financial position of non-financial corporations is sound and this, along with the prospects of increased earnings in the future, has helped to bring credit risk premiums down to a low level. What is more, both the *ex ante* and the *ex post* indicators of business risk and of financial risk have been performing favourably in recent years, irrespective of sectoral differences.

Households, against a backdrop of generous financial conditions, saw further rises in their indebtedness and in their financial burden. However, owing to the increase in their net wealth,

the financial position of households remained sound. Nevertheless, risks related to the high levels of debt, the behaviour of interest rates and house prices remain in place, the latter having grown at a high though slightly slowing rate.

The growth in activity of Spanish deposit institutions can also be attributed to the buoyancy of their business abroad, due partly to the favourable situation of the world economy, particularly the Latin American economy with its further strong growth in the first half of 2005. The geographical distribution of financial assets abroad has changed, becoming more concentrated in Europe, particularly the UK. As regards business areas, the relative weight of the private sector increased at the expense of interbank and public debt operations. The risk profile of financial assets abroad decreased, both in absolute terms and in relation to own funds.

In June this year doubtful assets rose significantly after falls in the last two years and holding practically unchanged until May 2005. This rise is due mostly to the changes made by CBE 4/2004, which tightened the definition in that it requires all the outstanding amount of loans to be recorded as doubtful when one instalment becomes past-due by three months. Therefore, despite the notable increase in activity, the doubtful assets ratio has risen, although it remains at the low levels of the previous years. Moreover, the probability of default (PD), an *ex post* indicator of risk that allows the stability of deposit institutions to be measured more accurately, along with the analysis of the risk profile of debt instruments (securities purchased, deposits placed and credit granted, among others), show that the level of *credit risk* in the balance sheets of institutions is at relatively low levels.

The brisk pace of activity of Spanish institutions is also discernible in the behaviour of the assets of mutual funds and pension funds run by management companies owned by banks. The information available shows that insurance activity in general, and that of insurance companies related to banks in particular, has grown. Broadly, the cushion above and beyond the minimum solvency margin reflects the increased strength of these companies during the past year.

Stock market *liquidity* has trended favourably with no particular pressure apparent. Institutions saw a further increase in their debit balance with the resident private sector, which continued to stimulate recourse to asset securitisation and to the issuance of covered bonds. The new accounting rules did not curb this activity.

The international financial markets have performed positively in 2005 in line with the favourable global macroeconomic setting, and have even proved capable of absorbing without strain the adverse shocks associated with certain bouts of instability stemming from the idiosyncratic problems of certain large automobile corporations and from the July terrorist attacks in London. As for Spanish firms, *market risk* was on a declining trend in the first half of the year.

Profitability

The results of Spanish deposit institutions confirmed the favourable trend noted in recent Financial Stability Reports. The return on equity (ROE) was, on average, again well above the yield on Spanish long-term public debt. This was the general rule for a good number of deposit institutions; at 75% of them the ROE stood between 5% and 15%.

The favourable performance of results should be set against the backdrop of the more than 10% growth of the three income statement margins (net interest margin, gross margin and net operating margin). That said, the aforementioned strong buoyancy of activity, largely responsible for this strong results performance, explains why, in relative terms, these margins did not increase with respect to the previous year. Once again, deposit institutions may be said to have demonstrated their commitment to the containment of operating costs, which is so im-

portant when it comes to operating successfully in an environment as competitive as the present one. This effort is reflected in a further improvement in the sector's efficiency ratio.

Compared with European banks, Spanish institutions enjoy a good position in terms of profitability, which is evidenced by substantially higher ROE levels than the EU average and, more particularly, than the average for euro area credit institutions as a whole.

The greater profitability of Spanish deposit institutions is underpinned by their higher net interest and gross margins. Contributing to this is the buoyancy of activity in Spain and in Latin America, which enables higher margins to be achieved. Furthermore, the favourable situation in terms of efficiency leads to a substantially higher net operating margin on average for Spanish institutions.

The stock exchange prices of the large Spanish banks performed favourably, on a very similar footing to that of the other large European banks. The risk indicators based on market information (implied volatilities, risk premiums on CDs, betas, etc.) remained at a relatively stable level, similar to that of their European counterparts.

Solvency

The solvency ratios of Spanish deposit institutions decreased slightly in June 2005 compared with the same period of 2004, although they were well above the minimum regulatory requirement. This decrease, which came about because the growth of capital requirements outstripped that of own funds, confirms the trends reported in previous FSRs. However, part of this decrease is temporary and related to the adjustment process derived from the acquisition of a large UK institution by a Spanish one at the end of 2004.

The increase in tier 1 capital was basically due to a rise in reserves, which were boosted by retained profits and by capital increases. This was countered by the simultaneous growth in goodwill. Tier 2 capital also contributed to the expansion of total capital: first, because of revaluation reserves arising from the application of the new accounting rules; and, second, because of the continued buoyancy of subordinated debt.

Capital requirements, which as mentioned above grew more than own funds, rose owing to the aforementioned acquisition of a large UK institution and to the notable rise in loans and receivables in business in Spain. This was a general phenomenon among deposit institutions that was largely linked to financing to the construction and property development sector and to households for house purchase.

Compared with those of European banks, the tier 1 and total solvency ratios stand slightly below the European average, although well above the minimum regulatory requirements.

In short, the considerable dynamism buoyancy of activity both in business in Spain and as reflected in the greater contribution from foreign business, along with the improvement in efficiency, enabled Spanish deposit institutions to post high levels of profitability while holding their solvency ratios substantially above the regulatory minimum. The buoyancy of activity requires institutions to exercise increasingly rigorous credit risk management, because the prolonged economic growth and low default rate in the Spanish economy could lead to excessive laxity in borrower screening policies.

I.1 Introduction to Spanish deposit institutions' risk

CHANGE OF ACCOUNTING FRAMEWORK

The *public financial statements* in the new accounting Circular issued by the Banco de España (CBE 4/2004) differ substantially from those of its predecessor, CBE 4/1991. These changes affect the measurement bases (e.g. use of fair value), the scope of consolidation (in the public financial statements, not only credit institutions, but also insurance companies and non-financial corporations have to be consolidated) and the presentation of information (Box I.1).

Financial assets are recorded in the public balance sheet net of so-called valuation adjustments, which, inter alia, include adjustments for impairment losses. The classification of financial instruments has little in common with the previous one, since assets and liabilities are grouped into categories based on management and purpose, whereas under CBE 4/1991 the presentation was based more on the nature of the financial instrument in question (e.g. credit or debentures and other fixed-income securities). Table I.1 sets out the content of the main categories of financial assets and liabilities.

On the *assets* side, the five main portfolios (financial assets held for trading, other financial assets at fair value through profit or loss, available-for-sale financial assets, loans and receivables and held-to-maturity investments) represented 91% of total assets in June 2005 (Table I.2). The most important of them, in terms of relative weight in total assets, is loans and receivables, with 68.1% of total assets. Within this portfolio, the item with the largest relative weight is loans and advances to other debtors (86.2% for all deposit institutions), followed by loans and advances to credit institutions (12%).

The greater relative importance of the loans and receivables portfolio is apparent in both commercial and savings banks (Chart I.1A and B), although more markedly so in the latter (73.6% compared with 63.9%). Within this portfolio, in both cases the item with the greatest relative weight is loans and advances to other debtors (85.3% in commercial banks and 87.4% in savings banks), followed by loans and advances to credit institutions (12.3% in commercial banks and 11.6% in savings banks).

For all deposit institutions, the order by relative weight of the other portfolios is available-for-sale financial assets (10.3%), in which debt securities (78.9%) are distinguished from other equity instruments (21.1%), and financial assets held for trading (9.6%). Most notable within the latter are debt securities (50.3%), trading derivatives (26.3%), loans and advances to other debtors and other equity instruments, the latter two each with a relative weight of 9%.

For commercial banks the relative weight of financial assets held for trading is 14.2%, while for savings banks it is only 2.7%. This, along with the high relative weight of their loans and receivables portfolio, points to certain differences in the type of business conducted by savings banks, which is more based on customer credit. In both cases, the most notable component of the financial assets held for trading is debt securities (50.9% in commercial banks and 44.9% in savings banks), followed by trading derivatives (24.9% in commercial banks and 38.4% in savings banks). However, whereas in commercial banks the loans and advances to other debtors component of this portfolio has a weight of 10.4%, in savings banks it is very small (1.2%). For other equity instruments the situation is the opposite (14.2% in savings banks and 8.9% in commercial banks).

ACCOUNTING DEFINITIONS

TABLE I.1

Financial assets are grouped in five main portfolios: financial assets held for trading, other financial assets at fair value through profit or loss, available-for-sale financial assets, loans and receivables, and held-to-maturity investments.

Loans and receivables basically include untraded financial assets that represent debts for their issuer or obligor. These assets are carried at amortised cost.

Available-for-sale financial assets include the debt securities not earmarked to be held to maturity nor held for trading nor included in the institution's portfolio of other financial assets at fair value through profit or loss, and the equity instruments (shares) of firms other than subsidiaries, associates and jointly-controlled entities not carried at fair value through profit or loss. Available-for-sale assets are carried at fair value and changes in their value are recorded in equity except when they are realised, whereupon these changes are reflected in the income statement. Nevertheless, equity instruments for which there is no reliable fair value are carried at cost.

Financial assets held for trading include the financial assets that institutions intend to realise in the short-term, and trading derivatives. These assets are carried at fair value and changes in their value are reflected in the income statement. Unlike under CBE 4/1991, trading derivatives are considered to be financial instruments recorded in the balance sheet on the assets side or on the liabilities side depending on whether their fair value entails, respectively, a contractual right or obligation to exchange financial instruments with a third party under conditions that are potentially favourable or unfavourable at the balance sheet date.

Held-to-maturity investments are carried at amortised cost and include the fixed-term debt securities that the institution has the intention and the financial ability to hold to maturity. Under the new circular, if more than an insignificant part of the held-to-maturity investments portfolio is sold or reclassified, no financial asset may be classified as held-to-maturity or held in this portfolio for a period of two years.

Other financial assets at fair value through profit or loss include, for example, hybrid instruments not held for trading that must be measured entirely at fair value, financial assets managed jointly with liabilities under insurance contracts and financial derivatives held for the purpose of reducing exposure to changes in fair value.

The inclusion of *hedging derivatives* and of *macro-hedges (portfolio hedges)* on the balance sheet is a change introduced in the new circular. The latter instruments provide a means, in a given portfolio, of hedging the interest rate risk on an amount of financial assets that form part of the whole but are not identified with specific instruments.

The new public balance sheet explicitly distinguishes between *liabilities and equity.* On the liabilities side, the new circular distinguishes four broad categories in which financial liabilities are classified on the basis of how they are managed and measured: financial liabilities held for trading, other financial liabilities at fair value through profit or loss, financial liabilities at fair value through equity and financial liabilities at amortised cost.

Financial liabilities at amortised cost is the only portfolio in which liabilities are not carried at fair value. This portfolio includes deposits from customers (other creditors), debt certificates including bonds and deposits from credit institutions.

Financial liabilities held for trading include trading derivatives, other trade certificates including bonds and short positions.

Other financial liabilities at fair value through profit or loss include hybrid financial liabilities not held for trading that have to be measured entirely at fair value.

Financial liabilities at fair value through equity includes financial liabilities associated with available-for-sale financial assets arising as a result of the transfer of assets over which the institution retains control and has not substantially transferred or retained the related risks and rewards. These assets are measured at fair value through equity.

Finally, *equity* includes own funds, composed basically of reserves and share premium, and valuation adjustments, among which are adjustments to available-for-sale financial assets (unrealised changes in the fair value of financial assets included in this portfolio) and exchange adjustments, where the exchange differences occurring in equity are recorded.

PUBLIC CONSOLIDATED BALANCE SHEET TABLE I.2

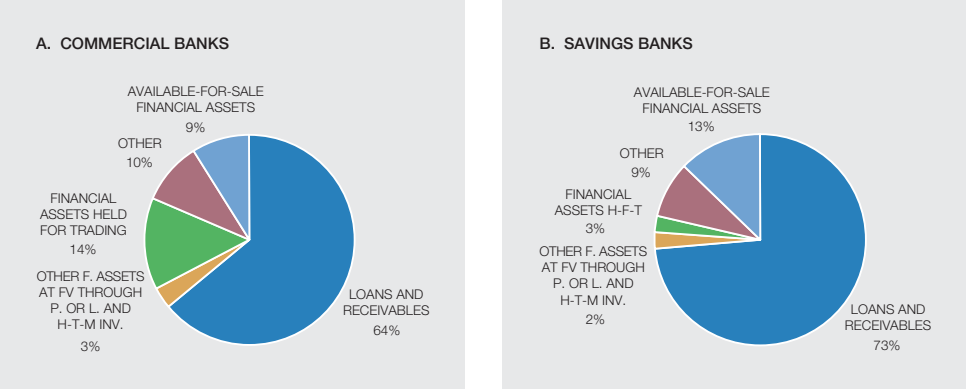
Deposit institutions. June 2005

	€ m	% OF ASSETS		€ m	% OF LIABILITIES AND EQUITY	% OF LIABILITIES
Cash and balances with central banks	38,185	1.7	Financial liabilities held for trading	144,913	6.4	6.8
Financial assets held for trading	216,872	*9.6*	*Debt certificates including bonds*	*19,192*	*0.9*	*0.9*
Debt securities	*109,011*	*4.8*	*Short positions*	*23,484*	*1.0*	*1.1*
Other equity instruments	*20,432*	*0.9*	*Trading derivatives*	*57,826*	*2.6*	*2.7*
Trading derivatives	*57,011*	*2.5*	*Other*	*44,411*	*2.0*	*2.1*
Other	*30,418*	*1.3*				
Other financial assets at fair value through profit or loss	43,123	1.9	Other financial liabilities at fair value through profit or loss	14,928	0.7	0.7
			Financial liabilities at fair value through equity	1,070	0.0	0.1
Available-for-sale financial assets	232,075	10.3	Financial liabilities at amortised cost	1,764,125	78.1	83.3
Debt securities	*183,054*	*8.1*	*Deposits from credit institutions*	*241,751*	*10.7*	*11.4*
Other equity instruments	*49,020*	*2.2*	*Deposits from other creditors*	*1,092,397*	*48.4*	*51.6*
Loans and receivables	1,537,514	*68.1*	*Debt certificates including bonds*	*298,989*	*13.2*	*14.1*
Loans and advances to credit institutions	*183,950*	8.1	Other	130,988	5.8	6.2
Loans and advances to other debtors	*1,325,725*	58.7	Changes in the fair value of the hedged items in portfolio hedges of interest rate risk	1,967	0.1	0.1
Other	*27,839*	1.2	Hedging derivatives	13,830	0.6	0.7
Held-to-maturity investments	23,723	1.1	Liabilities associated with non-current assets held the sale	143	0.0	0.0
Changes in the fair value of the hedged items in portfolio hedges of interest rate risk	87	0.0	Insurance contract liabilities	83,807	3.7	4.0
Hedging derivatives	26,119	1.2	Provisions	39,025	1.7	1.8
Non-current assets held for sale	3,512	*0.2*	*Provisions for pensions and similar obligations*	*25,127*	*1.1*	*1.2*
Investments	15,290	*0.7*	*Provisions for taxes*	*1,364*	*0.1*	*0.1*
Insurance contracts linked to pensions	5,372	*0.2*	*Provisions for contingent exposures and commitments*	*2,639*	*0.1*	*0.1*
Reinsurance assets	4,252	*0.2*	*Other provisions*	*9,896*	*0.4*	*0.5*
Tangible assets	42,610	1.9				
Intangible assets	19,349	0.9	TOTAL LIABILITIES	2,118,136	93.8	100.0
Of which: goodwill	18,098	0.8				
				€ m	% OF LIABILITIES AND EQUITY	% OF EQUITY
Tax assets	26,649	1.2				
Repayments and accrued income	6,191	0.3	Minority interests	8,158	0.4	5.8
Other assets	16,852	0.7	Valuation adjustments	17,025	0.8	12.2
			Available-for-sale financial assets	*15,408*	*0.7*	*11.0*
			Exchange differences	*1,802*	*0.1*	*1.3*
			Other	*–185*	*0.0*	*–0.1*
			Own funds	114,454	5.1	82.0
			Capital or endowment fund	*9,184*	*0.4*	*6.6*
			Share premium	*32,494*	*1.4*	*23.3*
			Reserves	*65,085*	*2.9*	*46.6*
			Other	*7,691*	*0.3*	*5.5*
			EQUITY	139,637	6.2	100.0
TOTAL ASSETS	2,257,773	100.0	TOTAL LIABILITIES AND EQUITY	2,257,773	100.0	

SOURCE: Banco de España.

ASSET STRUCTURE OF THE PUBLIC BALANCE SHEET CHART I.1

Commercial banks and savings banks. June 2005



SOURCE: Banco de España.

The relative weight of available-for-sale assets for savings banks is 12.8%, four percentage points more than for commercial banks (8.9%). The internal composition of this portfolio differs considerably between commercial banks and savings banks: debt securities represent 89% in the former against 67% in the latter, while other equity instruments account for 11% and 38%, respectively.

The relative weight of the held-to-maturity investments portfolio for all deposit institutions is 1.1%. Again, there are substantial differences between commercial and savings banks: for the former its relative importance is very low (0.3%), while for savings banks it is somewhat higher (2.3%). Some institutions preferred to classify certain assets-side debt securities as available for sale rather than commit themselves to holding them until maturity. This is reflected in the above-mentioned higher relative weight of the available-for-sale financial assets portfolio in savings banks than in commercial banks. However, this latter difference could also be due to the greater reclassification, more marked in certain institutions, of associates as available for sale.

Other financial assets at fair value through profit or loss have a low weight (1.9%) for deposit institutions as a whole. If commercial banks are distinguished from savings banks, however, the situation is different, since for the former the relative weight of this portfolio is 3% and for the latter it is 0.1%.

The other asset items outside the five large portfolios in which financial assets are classified have a low relative weight which, nonetheless, amounts to 9.1% in all. The most noteworthy among them are tangible assets (1.9%), cash and balances with central banks (1.7%), tax assets (1.2%) and hedging derivatives (1.2%). The inclusion of hedging derivatives and of portfolio hedges in the balance sheet is one of the changes introduced by the Circular, although their relative importance is slight, being almost nil in the case of portfolio hedges. Intangible assets, of which goodwill represents 94%, have a low relative weight (0.9%).

If commercial and savings banks are compared for the items mentioned above, two basic differences become apparent. First, for savings banks tangible assets represent 2.6% of total assets, while for commercial banks they are only 1.4%. The more closely-knit branch network of savings banks, along with their more common practice, as permitted in first-time application of the new Circular, of tangible asset revaluation using fair value, explain this difference. Second, intangible assets make up 1.4% of the total assets of commercial banks, compared with 0.1% for savings banks, in line with the lower relative weight of goodwill in these latter institutions.

IMPACT OF INTERNATIONAL ACCOUNTING STANDARDS AND THE NEW BANCO DE ESPAÑA ACCOUNTING CIRCULAR (CBE 4/2004)

BOX I.1

From 1 January 2005 all companies with securities publicly traded on a regulated EU market have to prepare and present their consolidated financial statements in accordance with International Accounting Standards (IAS). Among other aims, the adoption of IAS by the EU seeks to contribute to the consolidation of a single financial market in the Union. The Banco de España fully shares this aim and recognises that accounting rules have to foment the transparency and comparability of institutions. At the same time, it is considered that accounting rules must be consistent with best practices in risk management.

It was with these considerations in mind that the Banco de España drafted Circular 4/2004, which replaces Circular 4/1991. The new Circular enables Spanish credit institutions to comply with IAS. Also, it recognises their special features and thus takes the most prudent course whenever various options are permitted under international rules, while at the same time seeking to prevent the competitive playing field from being altered by the adoption of one or another accounting option.

The new Circular introduces major changes in the accounting framework in place up to now. The most important of them are described below[1].

CBE 4/2004 appreciably changes the focus adopted up to now. Whereas before it was centred on the protection of external funds entrusted to institutions, now it is considered that financial statements have to provide information basically to investors. The information provided must be significant, reliable and comparable, and has to be included in institutions' annual accounts: balance sheet, income statement, statement of changes in equity (a new development), statement of cash flows and explanatory notes to financial statements. The explanatory notes are one of the main changes in this Circular with respect to its predecessor and their aim is to complete, amplify and comment on the information offered in the other statements. In fact, the explanatory notes become a basic instrument for understanding how the reported figures have been prepared, the levels of risk incurred and the way in which risk is managed.

CBE 4/2004 also represents a certain change in the approach to measurement. Thus the Circular gives more importance to the use of present value in the financial statements, in order to meet the financial reporting aim mentioned above. A significant change in this respect is the inclusion of fair value, which is defined in the Circular as "the price that would rationally and justifiably be obtained by a seller and would be most advantageous for a purchaser".

The fair value of instruments traded in an active market coincides with market value. However, in the absence of such a market, i.e. one in which, among other things, prices are formed with a certain frequency, prices are available to the public and the volume traded is sufficient, the institutions will have to estimate the fair value. This requires a certain technique to be applied and certain assumptions to be made, so the estimate depends largely on the judgement of management.

The Circular does not recommend any particular technique, but rather offers general guidelines on how to select one and lists a series of factors that the measurement method should take into account. Furthermore, not all financial instruments have to be recorded at fair value; rather, the value recognised will depend on the type of portfolio. Thus, on the assets side, fair value is not used for held-to-maturity investments or loans and receivables, and on the liabilities side it is not used for financial liabilities at amortised cost (deposits from other creditors and from credit institutions). In any event, the explanatory notes do have to disclose the differences between book value and fair value.

What has been said so far indicates that the new accounting Circular will require a greater degree of responsibility from managers in the preparation of financial information, in line with the requirements of IAS.

The previous Circular already called for transactions to be treated according to their economic nature, but Circular 4/2004 emphasises the importance of the economic substance of transactions as against their legal form, so as not to detract from the reliability of the information. Thus, for example, a security, irrespective of its legal name, has to be classified as a liability and not as equity if obligatory remuneration has been established, even when it is conditional on profit for the issuer.

Strictly speaking, the consolidated financial statements are also a reflection of the prevalence of substance over form, since it is considered that these, rather than the individual financial statements, are more important for analysis. The new Circular establishes that all subsidiaries, whatever their activity (for example, insurance and non-financial corporations) have to be fully consolidated.

CBE 4/2004 provides an accounting treatment of so-called business combinations (e.g. mergers or acquisitions) which again is independent of the legal form of the transaction: liabilities and assets acquired are to be recognised at fair value and goodwill is the positive difference from the purchase price. Goodwill is an asset which recognises that in the future there will be certain economic rewards that at the time of acquisition are not reflected in the purchase price. It can be inferred from this that it is difficult to measure the existence of, and any changes in, goodwill. In this respect, the Circular does not require goodwill to be amortised systematically, but it does require goodwill to be checked for impairment. On verification of impairment, the goodwill has to be written down and subsequent reversal of write-downs is not permitted.

The securitisation of loans has also seen changes in the new accounting framework, since the Circular requires that assets can be derecognised if the institution has substantially transferred, or not substantially retained, the risks and rewards associated with the asset. This calls for each case to be analysed specifically.

Derivative instruments shall be classified as assets or liabilities according to whether, at the balance sheet date, their fair value indi-

1. These changes are explained in detail in the article by J. Pérez Ramírez, "La perspectiva económica de las Normas de Información Financiera" in *Estabilidad Financiera* n.º 8, pp. 9-38, Banco de España.

cates a right or an obligation for the institution. Changes in derivative instruments shall be reflected in the income statement, except in the case of accounting hedges. The general treatment of products incorporating an embedded derivative calls for distinguishing between the derivative and the hybrid instrument.

As regards hedges, a distinction must be made between financial hedges and accounting hedges, it being the latter that are recognised by the Circular provided that they meet certain requirements as to their effectiveness and documentation.

Depending on the risk that is being hedged, hedges are classed as fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation. Finally, the Circular also defines so-called macrohedges (portfolio hedges), i.e. the possibility, in a given portfolio, of hedging the interest rate risk on an amount of financial assets or liabilities that form part of the whole but are not identified with specific instruments.

In short, the changes mentioned above, which are some of the most significant ones introduced by CBE 4/2004, will have effects that cannot be neglected. Accordingly, the Banco de España has made an initial assessment of the impact of the new accounting Circular, the results of which are discussed below.

In terms of total assets, the impact is relatively small. However, within assets certain variations can be appreciated. The trading book ("financial assets held for trading"), which includes financial assets acquired with the intention of realising them in the short term, becomes more sizeable. This is largely because derivatives not classified as accounting hedges are no longer recorded in off-balance-sheet items, but in the trading book.

The available-for-sale financial assets portfolio also changes. This portfolio is where institutions include assets when no decision has been made either to realise them in the short term or to hold them to maturity. There are at least two reasons for the increase in this portfolio. First, debt instruments are now classified here that were previously included in held-to-maturity investments, which now decreases. Under the new rules, no financial asset may be classified as held-to-maturity or held in this portfolio for a certain length of time if more than an insignificant portion of this portfolio has been sold or reclassified. The second reason for the increase in the available-for-sale portfolio is that it now has classified in it a good part of what was previously deemed to be associates. The concept of significant influence, and the interpretation of the criteria included in the Circular (representation on the board of directors, participation in policy-making processes, etc.), explain the change.

Tangible assets have also been affected, because some institutions have revalued them (thereby increasing own funds). In first-time application of the Circular, it is permitted to revalue them at fair value provided that the asset can be freely disposed of.

Finally, on the assets side, intangible assets decrease owing to the decline in goodwill. Again, the explanation is twofold: first, because of the aforementioned reclassification of associates, and, second, because of their reduction, with a charge to reserves, by some institutions that stopped accounting for investments in subsidiaries as goodwill once control had been secured.

Noteworthy as regards the composition of liabilities is the relative stability of financial liabilities at amortised cost, the portfolio with by far the largest relative weight. A part of the small change is explained by the classification of preference shares as financial liabilities rather than, as before, under minority interests. Notable among the items that change the most is the liabilities trading book ("financial liabilities held for trading") which, like the assets-side trading book, increases due to the inclusion of derivatives not deemed to be accounting hedges.

Also, provisions for pensions and similar obligations increase, since now the amounts covered by group insurance companies are included because the risk is not considered to have been totally transferred.

Own funds for accounting purposes decrease despite the rise in profit for the period and in revaluation reserves (the latter basically because of the definitive write-off of exchange differences and the revaluation of equity and fixed-income securities, which are now included in the available-for-sale portfolio).

The above-mentioned decline in accounting own funds is due, first, to the diminution in reserves (reclassification of associates, accounting changes relating to acquisition of investments in entities over which control already exists, etc.), and, second, to the decrease in minority interests, basically due to the treatment of preference shares which, for accounting purposes, are deemed to be financial liabilities.

This initial assessment also sought to analyse the impact of the accounting changes on regulatory capital, taking into account the action of prudential filters. In this respect, the results show a moderate effect on regulatory capital, which tends to rise slightly. Thus, although the reduction of reserves and minority interests is detrimental to Tier 1 capital, the classification of preference shares as regulatory capital offsets this effect. What is more, the analysis shows that the relative increase in total capital came about also from an increase in Tier 2 capital, basically due to the aforementioned revaluation of tangible assets by some institutions.

In acknowledgement of the possible impact of the significant changes introduced by the accounting circular, the Banco de España reviewed Circular 5/1993 on own funds and consolidated supervision of credit institutions. The review was incorporated into Circular 3/2005 of 30 June, which does not alter the current definition of eligible capital or, in any substantial way, the accounting basis for the calculation of risk. That is to say, insofar as prudential filters are concerned, the Banco de España's aim has been to determine what instruments are considered to be eligible, not on the basis of the accounting distinction between liabilities and equity, but in terms of their capacity to absorb losses and their degree of permanence in the institution.

For all deposit institutions, *liabilities* are equal to 93.8% of total assets, and hence the relative weight of equity is 6.2%. This distribution is similar in commercial and savings banks, although for the former the relative weight of equity is somewhat higher (7.2%) than that in savings banks (5.4%).

By far the most significant portfolio on the liabilities side is financial liabilities at amortised cost (83.3% of total liabilities). Noteworthy in this portfolio for their relative importance are deposits from other creditors (61.9%), debt certificates including bonds (16.9%) and deposits from credit institutions (13.7%).

Comparison of commercial and savings banks (Chart I.2A and B) shows significant differences that once again evidence differing specialisations in the type of business of these groups of institutions. Thus the relative weight of financial liabilities at amortised cost for savings banks is 89% of total liabilities, while for commercial banks it is 79.5%. Moreover, the internal composition of this portfolio shows major differences: the relative weight of deposits from other creditors is 69.7% for savings banks against 55.3% for commercial banks, where debt certificates including bonds and deposits from credit institutions have a higher relative weight (5.9 pp and 4.5 pp, respectively, compared with savings banks).

Financial liabilities held for trading account for 6.8% of total assets. The main component of this portfolio is trading derivatives (39.9%). Once again, there are significant differences between commercial and savings banks. Thus the relative weight of financial liabilities held for trading in savings banks is only 1.3%, with their most notable component being trading derivatives (80.4%). For commercial banks this portfolio has a weight of 10.3% of total liabilities and, although trading derivatives predominate, they have an appreciably lower weight (37.1%).

Other financial liabilities at fair value through profit or loss have a weight of only 0.7%, while financial assets at fair value through equity only amount to 0.1% of liabilities. The situation is similar in commercial and savings banks, although in the latter other financial liabilities at fair value through profit or loss have a weight of 1.3%.

The relative weight of hedging derivatives and portfolio hedges is, as on the assets side, low: 0.6% and 0.1%, respectively. However, insurance contract liabilities have a weight of 3.9%, with the figure being similar in commercial banks (4.5%) and savings banks (3.2%).

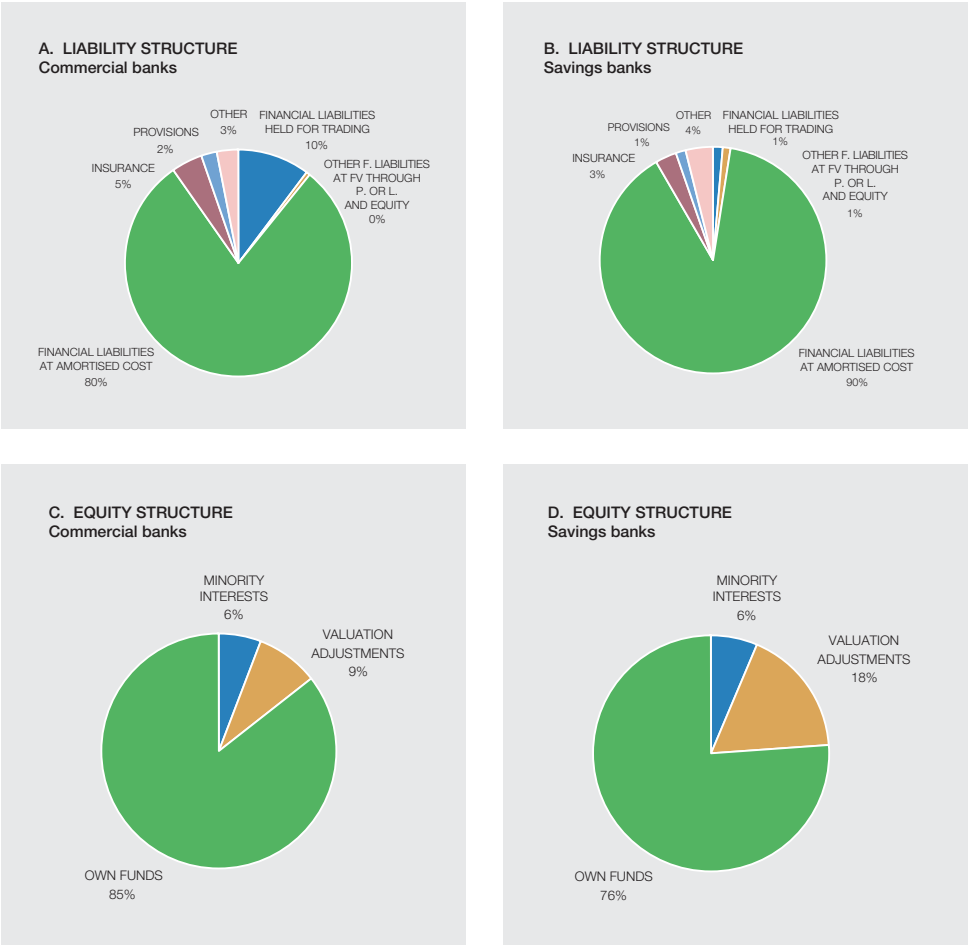
On the liabilities side, provisions make up 1.8%. These do not include the previous bad debt and country-risk provisions, which are now presented as a reduction of assets through valuation adjustments. Therefore, these provisions relate to pensions and similar obligations (64% of the total), taxes (3.5% of the total), contingent exposures and commitments (6.8%) and other (25.4%). Although the relative weight of this item is similar in commercial and savings banks, its composition is less so: in commercial banks it comprises mainly pension provisions (71.9%) and other (21.2%), while in savings banks pension provisions make up 43.2%, other provisions 36.8% and provisions for contingent exposures and commitments 16.7%.

Finally, as regards *equity* (6.2% of the balance sheet), the bulk of it is naturally own funds (82%), which in turn consists basically of reserves and share premium (85.3% taken together).

Valuation adjustments make up 12.2% of total equity. 90.5% of them are adjustments to available-for-sale financial assets, i.e. unrealised changes in fair value of financial assets included in

LIABILITY AND EQUITY STRUCTURE OF THE PUBLIC BALANCE SHEET CHART I.2

Commercial banks and savings banks. June 2005



SOURCE: Banco de España.

that portfolio. The other 9.5% is due to adjustments for exchange differences, which is the account where the exchange differences occurring in equity are recorded. Regarding this latter account, some institutions opted, in their first-time application of the new accounting rules, to write off these exchange differences. Finally, minority interests make up 5.8% of equity.

Comparison of commercial and savings banks (Chart I.2C and D) shows that the latter have a higher weight of valuation adjustments (17.7% as against 8.5%) and also of minority interests (6.3% as against 5.9%). The weight of own funds within equity is 9 pp higher in commercial banks than in savings banks. These differences in composition stem from the dissimilar legal nature of these two types of institution and from their distinct strategies of investment in corporate holdings.

The *confidential consolidated balance sheets* introduced by the new CBE 4/2004 differ substantially from those in place until now. However, these statements offer greater scope for comparison with prior periods than do the public financial statements, since financial assets and liabilities are classified into portfolios not according to management and measurement method, but rather according to the nature of the related financial instrument (Table I.3). Also, the confidential statements, unlike the public ones, distinguish the nominal amounts of financial assets and the valuation adjustments to them. The data available in June 2005 show that the relative significance of these adjustments is small. The most significant adjustments in

CONFIDENTIAL CONSOLIDATED BALANCE SHEET TABLE I.3

Deposit institutions

	JUNE 2005	RELATIVE WEIGHT IN JUNE 2005	RELATIVE WEIGHT IN JUNE 2004		JUNE 2005	RELATIVE WEIGHT IN JUNE 2005	RELATIVE WEIGHT IN JUNE 2004
Cash and balances with central banks	39,232	1.7		Deposits from central banks	46,284	2.0	
Excluding valuation adjustments	*39,191*	*1.7*	*1.7*	*Excluding valuation adjustments*	*46,258*	*2.0*	*1.9*
Loans and advances to credit institutions	232,116	10.0		Deposits from credit institutions	392,135	16.9	
Excluding valuation adjustments and doubtful assets	*231,526*	*10.0*	*11.2*	*Excluding valuation adjustments*	*389,685*	*16.8*	*18.9*
Money market operations through counterparties	2,435	0.1		Money market operations through counterparties	378	0.0	
General government	49,217	2.1		General government	56,513	2.4	
Excluding valuation adjustments and doubtful assets	*48,778*	*2.1*	*2.9*	*Excluding valuation adjustments*	*56,430*	*2.4*	*2.9*
Other private sectors	1,334,102	57.6		Other private sectors	1,099,372	47.5	
Excluding valuation adjustments and doubtful assets	*1,347,572*	*58.2*	*57.4*	*Excluding valuation adjustments*	*1,089,889*	*47.0*	*51.7*
Debt securities	344,685	14.9		Debt certificates including bonds	302,723	13.1	
Excluding valuation adjustments and doubtful assets	*343,210*	*14.8*	*16.8*	*Excluding valuation adjustments*	*295,874*	*12.8*	*10.1*
Other equity instruments	77,013	3.3	2.1	Trading derivatives	61,593	2.7	
Trading derivatives	57,296	2.5		Short positions	23,484	1.0	
Other financial assets	19,612	0.8		Subordinated liabilities	51,980	2.2	
Changes in the fair value of the hedged items in portfolio hedges of interest rate risk	87	0.0		*Excluding valuation adjustments*	49,295	2.1	2.1
Hedging derivatives	28,161	1.2		Other financial liabilities	34,587	1.5	
Non-current assets held for sale	916	0.0		Changes in the fair value of the hedged items in portfolio hedges of interest rate risk	1,967	0.1	
Investments	28,096	1.2		Hedging derivatives	14,677	0.6	
Excluding valuation adjustments	*28,130*	*1.2*	*2.5*	*Provisions*	*35,544*	*1.5*	
Insurance contracts linked to pensions	10,408	0.4	0.2	Tax liabilities	13,145	0.6	
Tangible assets	33,928	1.5		Accrued expenses and deferred income	9,164	0.4	
Intangible assets	19,013	0.8		Other liabilities	10,924	0.5	
Tax assets	26,491	1.1		Capital having the nature of a financial liability	20,715	0.9	
Prepayments and accrued income	6,597	0.3	0.4				
Other assets	7,325	0.3					
				TOTAL LIABILITIES	2,175,184	93.9	
				Minority interests	6,441	0.3	
				Valuation adjustments	18,724	0.8	
				Own funds	116,384	5.0	5.4
				TOTAL EQUITY	141,549	6.1	
TOTAL ASSETS	2,316,732			TOTAL LIABILITIES AND EQUITY	2,316,732		
Memorandum items							
Financing to the private sector	1,439,575	62.1	61.0				
Financing to general government	236,905	10.2	13.7				
Total doubtful assets	13,395	0.6	0.6				

SOURCE: Banco de España.

relative terms are seen in the credit to other private sectors, with a weight of nearly 2%. In fact practically all these adjustments are due to impairment losses, which were previously classified on the liabilities side as bad-debt and country-risk provisions for losses on credit to other private sectors. However, despite the advantages of this classification of financial assets and liabilities, comparable, to a greater extent, with that in place under CBE 4/1991, it is not possible to make a direct, full comparison of the amounts prepared under CBE 4/1991 and CBE 4/2004, since their criteria differ in important respects (Box I.1).

In June 2005 the total assets of Spanish deposit institutions posted a growth rate of more than 30%, up considerably on that recorded at the same date a year earlier (13%). This figure evidences the greater buoyancy of activity already noted in the last FSR, although it was also a result of the acquisition of a large UK institution by a Spanish one at the end of 2004. Also, the growth rate in June 2005 may have been affected by the changes introduced by the new accounting Circular. In fact, comparisons with the previous year should be based on 2004 data prepared according to the criteria of CBE 4/2004, but this information was not available at the date of preparation of this FSR. Accordingly, the 2004 data should be considered as estimates and hence subject to possible change. Among other things, the data estimated for 2004 do not take into account that, under the new Circular, the balance sheet contains financial assets not previously classified as such (e.g. trading derivatives), some securitised assets have had to be returned to the balance sheet and various institutions have revalued their tangible assets as a result of first-time application of the new Circular.

However, despite these caveats, which call for caution in any comparison with the previous year, the data do reveal the main trends in the activity of Spanish deposit institutions. The considerable buoyancy of total assets is explained by the sharp growth of *business in Spain* in line with that noted in the last FSR and with the continuing good health of the Spanish economy.

Foreign business grew significantly, the rates surging from nearly 2% to around 120%. While the world economy, particularly in the main Latin American countries, has been favourable, a good part of this strong growth in foreign business was due to the aforementioned acquisition of a UK institution. Indeed, the effects of this acquisition, which took place at the end of 2004, were analysed in the last FSR. All in all, the weight of foreign business held at high levels (23% of total assets).

As for the balance sheet structure, on the *assets* side financing to the private sector[1] has a relative weight of 62.1%, up 1.1 pp on the same period a year earlier. This slight increase in the relative weight of this item is due to its strong growth, at 40.8%, in June 2005. However, if the effect of the change in securitisation accounting method is factored out, credit growth is 37.1% year-on-year, up 2 pp on that posted in the last FSR.

The growth of financing to the private sector is largely explained by the buoyancy of business in Spain where, after adjusting for the effect of asset securitisation, the rate of change is 20.2%. The FSR once again notes that the main reason for this growth is secured credit to the private sector, since, after factoring out the effect of securitisation, it grew by 24.5%. However, as mentioned above, comparisons with the previous year must be regarded with some caution.

The buoyancy of financing to the resident private sector was enhanced by foreign business, where credit to the private sector is growing at more than 180% due to mortgage credit growth rates above 300%. As a result, the relative weight of financing to the private sector in foreign business rose from 44.1% to 56.9%. As noted in the last FSR, the acquisition of the aforementioned UK institution, which is highly specialised in the home purchase credit segment, largely explains this behaviour.

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1. Unlike in previous FSRs, and due to problems of comparison with past dates because of the differing sectorisation in CBE 4/1991 and CBE 4/2004, doubtful assets are not included. However, in June 2005, private sector doubtful assets amounted to only 0.9% of the financing granted to the sector.

Total doubtful assets, which grew by 28.1%, reversed the declining trend noted in recent FSRs. This behaviour can be attributed to the introduction of the new accounting Circular, which stipulates for doubtful assets that when an instalment becomes three months past-due, the whole outstanding balance of the transaction in the balance sheet must be classified as doubtful. The 2004 data, however, were not prepared in accordance with this rule, which accelerates the recognition of doubtful assets in the balance sheet. All in all, the relative weight of doubtful balances in total assets fell slightly from 0.62% to 0.58%. On comparison of the areas of business, the differences seen are those that were noted in the last FSR: the relative weight of total doubtful assets in Spain is 0.5%, as against 0.9% in foreign business.

The behaviour of financing granted by institutions, which grew substantially, and of doubtful assets, which also expanded considerably under the effect of the new accounting rules explained above, meant that the total doubtful assets ratio held steady between June 2004 and June 2005 (0.71%). On comparison of businesses, the June 2005 data confirm what was said in the last FSR, and although the doubtful assets ratio of foreign business is substantially above that of business in Spain (1.1% as against 0.58%), that difference is narrowing. The change in composition of foreign business, along with the favourable economic situation in Latin America, helps explain this.

Financing to general government, excluding doubtful assets, decreased in relative terms from 13.7% in June 2004 to 10.2%. This decline, which is in line with that noted in the last FSR, is attributable to business in Spain (down from 12.4% to 9.2%) and, above all, to foreign business, where, despite growing substantially in absolute terms, it dropped from 21.7% to 13.6%.

Other equity instruments grew substantially with respect to June 2004, rising to 3.3% of total assets, up 1.2 pp on the same period a year earlier. With respect to last FSRs, the current equity portfolio is not directly comparable with the former one, since a part of the securities recorded under this heading are now included in the investment portfolio, which in June 2005 had a weight of 1.2%, as against 2.5% in 2004. This decrease may be at least partly due to the reclassification of associates into available-for-sale assets by some deposit institutions. In any event, if the former equity portfolio is reconstructed according to CBE 4/1991 criteria for June 2005, the resulting relative weight is 4.4%, up 0.2 pp on the previous year. This relative stability against a background of strong growth in activity indicates that the growth rates of equity securities, in consonance with the favourable stock market sentiment in 2005, were high.

On the *liabilities* side, private-sector deposits grew considerably faster than in the previous period (25.8% as against 9.4%). Despite this, their relative weight in the balance sheet of Spanish deposit institutions declined appreciably to 47%. The behaviour of business in Spain and abroad was similar: in both cases the rates of change were high, basically in foreign business (12% and 94.3%, respectively), but there were declines in relative terms (sharper in business in Spain).

As already noted in the last FSR, deposits from credit institutions grew more than in the past year, posting a rate of 23.2 in June 2005, but their relative weight in the balance sheet decreased by 2.1 pp to 16.8%.

The performances of subordinated financing and of debt certificates including bonds confirmed the trends noted in the last FSR. Thus subordinated financing continued to grow at a rate of 40%, meaning that in relative terms it remained unchanged at 2.1%. The relative weight

of debt certificates including bonds, which reflected institutions' need to finance the expansion of their activity, increased by 2.7 pp to 12.8%.

Finally, the own funds of Spanish deposit institutions, although growing, remained in relative terms at similar levels to those in June 2004 (5.4% against 5% at present). The main captions in own funds by order of relative weight are reserves and share premium (84.7% of total own funds), capital (8%) and profit or loss for the period (7.9%), the latter having grown with respect to the previous year by somewhat more than 20%.

CBE 4/2004, in application of IFRS, broadened the scope of consolidation of credit institutions. In addition to the consolidable group of credit institutions, which as before includes all subsidiaries except insurance subsidiaries, it is now necessary to consolidate insurance companies and non-financial corporations forming part of a decision-making unit, even if no ownership interest is held in them. A decision-making unit is presumed to exist if, among other things, a credit institution holds a majority of voting rights in a subsidiary, it can appoint or remove a majority of the members of the board of directors or one or more companies are under the same management. The new accounting Circular includes sectoral information on groups of credit institutions separating the foregoing three elements: the consolidable group o credit institutions (subsidiaries and jointly controlled entities that are credit institutions, securities-dealer companies, securities agencies, real estate investment companies, companies managing collective investment undertakings, companies managing pension funds, portfolio management companies, venture capital companies and holders of equity instruments), insurance companies and other non-financial corporations. At the cut-off date for this FSR the sectoral information had not been finalised. The regular analysis will be included in the next FSR. In any event, the activities of asset management and underwriting are analysed below on the basis of the information available.

ASSET MANAGEMENT

The assets of collective investment undertakings and of pension funds run by *management companies owned by deposit institutions* amounted to €378,726 million in March 2005, up 13% and 3% on March and December 2004, respectively. The year-on-year increase was mainly due to the rise in the assets of capital market and money market mutual funds, which account for 5.7% of total growth, and to the strong surge of more than 50% in the assets of non-mortgage securitisation special purpose vehicles (SPVs), which contributed 4.1%. Analysis by geographical area of residence of the management company, which nearly coincides with the area in which the collective investment undertakings and pension funds are located, shows that the increase arose from very similar rates of growth (around 12%) of the assets managed in Spain and in Latin America, accounting for 10.3% and 1.6%, respectively, of total growth.

This growth slightly altered the composition of managed assets by type of institution: capital market and money market mutual funds lost more than 2 pp, representing 60% of total assets under management, non-mortgage securitisation SPVs continued to gain market share as they rose by 2.7 pp to 10.6%, and pension funds held practically unchanged at 17.8% (Chart I.3A). The breakdown by geographical area was nearly unchanged, with 81.4% of assets under Spanish management companies and 13.4% under Latin American management (Chart I.3B).

Subsidiaries of *commercial banks* managed €303,250 million in March 2005, which was 13% more than in March 2004, with a market share of 80.1% of the total managed by deposit institutions (77% in Spain and 100% in Latin America). This increase is the result of a rise in the assets of all the managed institutions, with the largest contributions corresponding to the as-

COLLECTIVE INVESTMENT INSTITUTIONS AND PENSION FUNDS (a) CHART I.3

SOURCE: Banco de España.

a. Data relate to December of each year, except in 2005, in which they refer to March, the last month for which information was available at the date of preparation of this FSR.

sets of capital market and money market mutual funds (4.8%), to those of non-mortgage securitisation SPVs (4.9%) and to those of pension funds (2.2%) (Chart I.3C). The composition of asset management by geographical area was practically unchanged with respect to that a year earlier, with Spain representing 78.25% and Latin America 16.7%.

Subsidiaries of *savings banks* managed 19.2% of the assets administered by deposit institutions (22.1% in Spain), with growth of 13.3%. This growth is the result of a general increase in assets managed by all types of collective investment undertakings and pension funds. The

main contributors to this performance were capital market and money market funds (9.5%) and mortgage securitisation SPVs (1.9%) (Chart 1.3.D). The composition of managed assets by geographical area of residence of the management company shows that 93.7% of the assets were managed in Spain (1.7 pp less than a year earlier), 1.3% in the rest of the EU-15 and the other 5% in other developed countries, the latter having gained 1.4%.

The composition of the assets of the institutions managed by commercial and savings banks differs not only in respect to the markets in which they are managed, but also in the amount of the assets of the various types of institutions managed, which is determined by the differing business specialisation and clientele of these two groups of banks. Thus in March 2005, 63.3% of the assets managed in Spain by commercial banks were in capital market and money market mutual funds, while for savings banks this figure was 73.6%; non-mortgage securitisation SPVs represented 12.7% for commercial banks and 4.2% for savings banks; pension funds accounted for 10.8% for commercial banks and 6.8% for savings banks; mortgage securitisation SPVs 5.2% for commercial banks and 13.2% for savings banks; and open-ended investment companies 6.4% for commercial banks and 1.9% for savings banks. This structure changes in the assets managed by commercial banks in Latin America, where 70.3% is in pension funds and 25.6% in capital market and money market mutual funds.

INSURANCE COMPANIES

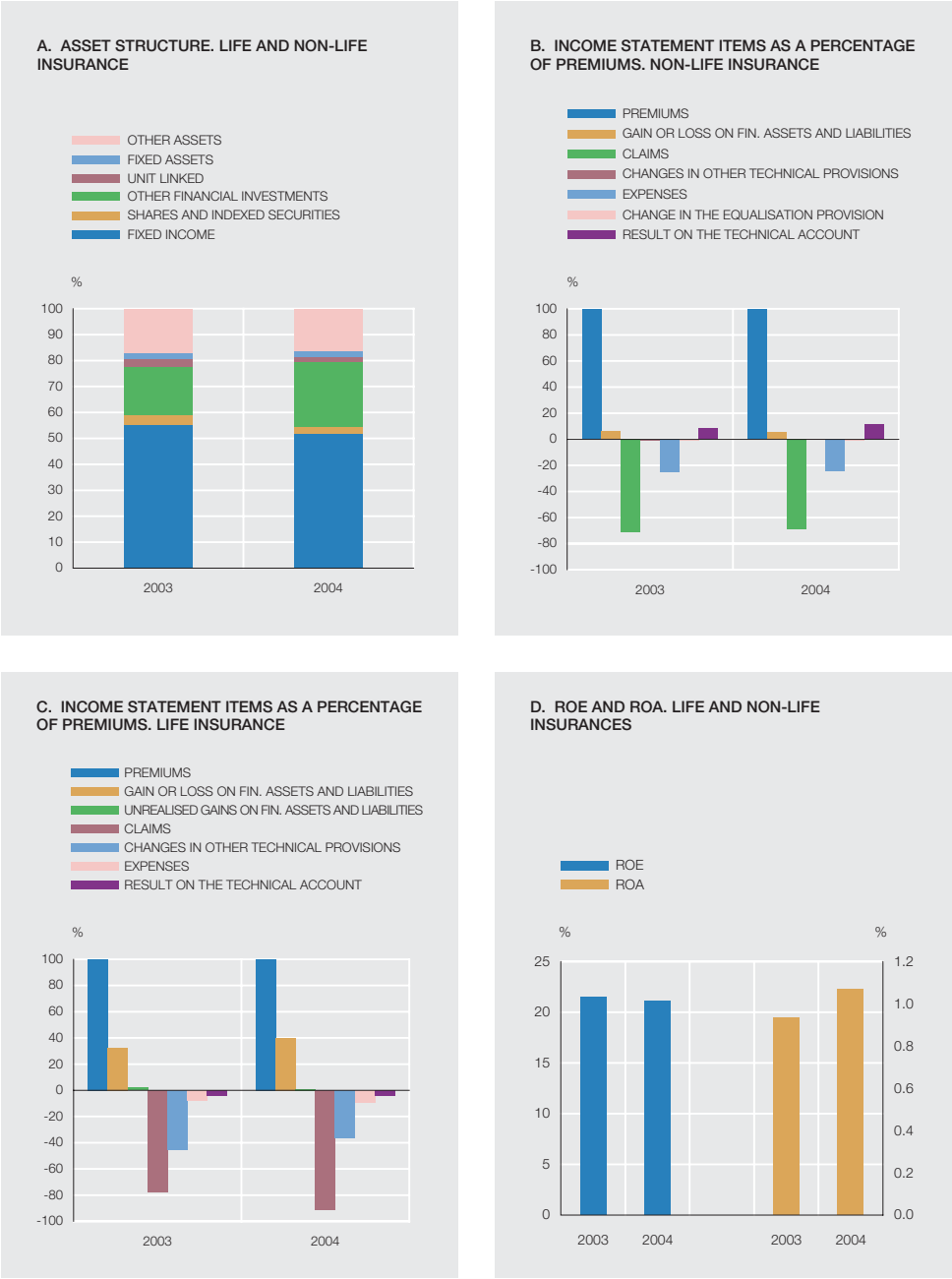
On provisional data, in December 2004 the assets of Spanish insurance companies grew by 7.7% with respect to December 2003. Net premiums earned, which are the main income of insurance companies, grew by 8.4%, recovering from the fall of 14.5% in 2003 (attributable to the decline in unit linked business and to the end of the process of externalisation of pension commitments). Information on insurance companies related to deposit institutions is not yet available for 2004.

The growth of insurance activity in 2004 is corroborated by the data published in the annual reports of the major companies in the sector. For a sample of six mixed insurance companies, including companies related to deposit institutions, with total assets representing around one-third of the aggregate assets of Spanish insurance companies, the growth was 18%. The *breakdown of consolidated assets* in December 2004 (Chart I.4A) shows that tangible fixed assets held for use in operations and for investment stood at 2.3% of total assets, which signifies a low exposure to the real estate market. Shares represented 2% of total assets (nearly 3% together with indexed securities). Again, price risk exposure in the equity market is very low. Fixed-income securities represented 51.6%, down from 55.3% in 2003, this weight being lost to other financial investments, which accounted for 25% compared with 20% a year earlier, mainly due to deposits placed with credit institutions and other investments. Investments linked to technical provisions represented 81.6% of assets, while investments on behalf of policyholders that assume the investment risk, and those tied to unit-linked policies, represented 2% of assets, with other assets representing 16.2%.

For *non-life insurance,* premium income net of reinsurance grew by 12.4% in 2004, while claims grew by 9%. The ratio of claims to premiums improved to 68.9% from 71% in 2003. Also, the expenses ratio improved to 24% of premiums in 2004 as compared with 25% in the previous year. This improvement in ratios that were already good in 2003 means that the insurance companies in the non-life sample analysed are at a favourable point in the insurance cycle. The net technical result, which does not take into account the gain or loss on financial assets and liabilities, increased by 136% to make up 5.8% of premiums compared with 2.8% in 2003. For its part, the gain or loss on financial assets and liabilities did not perform so well, since it fell by 1.7% to constitute 5.3% of premiums compared with 5.9% in 2003. All in all, the

INSURANCE COMPANIES CHART I.4

Sample of six large mixed insurance companies



SOURCES: Annual reports of the six companies analysed.

result on the technical account, which combines the net technical result and the gain or loss on financial assets and liabilities, increased by 44.7%, representing 11.2% of premiums compared with 8.7% in 2003 (Chart I.4B).

In *life insurance,* premiums grew by 2.5%. Net claims as a percentage of net premiums stood at 91.4%, as against 78% in 2003. The ratio of expenses to net premiums stood at 9.4%, against 7.8% in 2003. As a result, the net technical result worsened, with a gap of 36.4% between it and net premiums, compared with 28.8% in 2003. A highly significant part of the income of life insurance companies comes from the financial assets in which their technical provisions are invested. The net gain on financial assets and liabilities, expressed in terms of total assets, stood at 4.2% in 2004, as against 4% in 2003, and, moreover, this gain increased by 27% in 2004, represent-

ing 40% of net premiums, up 8 pp on 2003. The result on the technical account grew by 6.4% and represented 3.8% of premiums, against 3.7% in 2003 (Chart I.4C).

The result on the technical account of non-life insurance was equal to 106.6% of after-tax profit, while that of life insurance amounted to 30.9% (99.8% and 39.3% in 2003, respectively). After-tax profit grew by 35.5% in 2004. Both the premiums and the profits confirm, in this sample of companies, the favourable cyclical point of the non-life sector for the Spanish market as a whole and, to a large extent, for the European market as well. As a result, non-life insurance is gaining relative weight compared with life insurance. Thus for Spanish insurance companies as a whole, in 2001 life insurance premiums represented 54.5% of the sector, while in 2004 they represented 42.1%.

The favourable performance of activity, premiums and claims gave rise to a high ROE for the sample of insurance companies analysed, since it stood at 21.1% in December 2004, a similar level to that in 2003. ROA stood at 1.1%, as against 0.9% in 2003 (Chart I.4D). There was, however, a certain dispersion in the sample of entities analysed. The solvency margin exceeded the minimum requirement by 190%, compared with 179.4% in 2003, evidencing an increase in the strength of these companies during the past year.

RISKS

The entry into force of CBE 4/2004 brought changes in accounting for asset securitisation. Previously, securitised assets were derecognised regardless of the degree of transfer of credit risk and, as a result, the amount of loans and receivables on the balance sheet was lowered. The new Circular goes to the crux of the matter, and if the risk is substantially transferred, they are derecognised, whereas if the risk is substantially retained, they are not derecognised. Furthermore, the rule requires all transfers made since 1 January 2004 to be examined and, if there is no transfer of risk, they must be reinstated in the balance sheet. Previous FSRs have discussed the fact that, given the characteristics of many securitisation transactions in Spain (with significant credit enhancements which give rise to absorption of a high percentage of the initial losses), it can be expected that a fairly high percentage of these transactions will return to the balance sheet, distorting the lending figure and its rate of change.

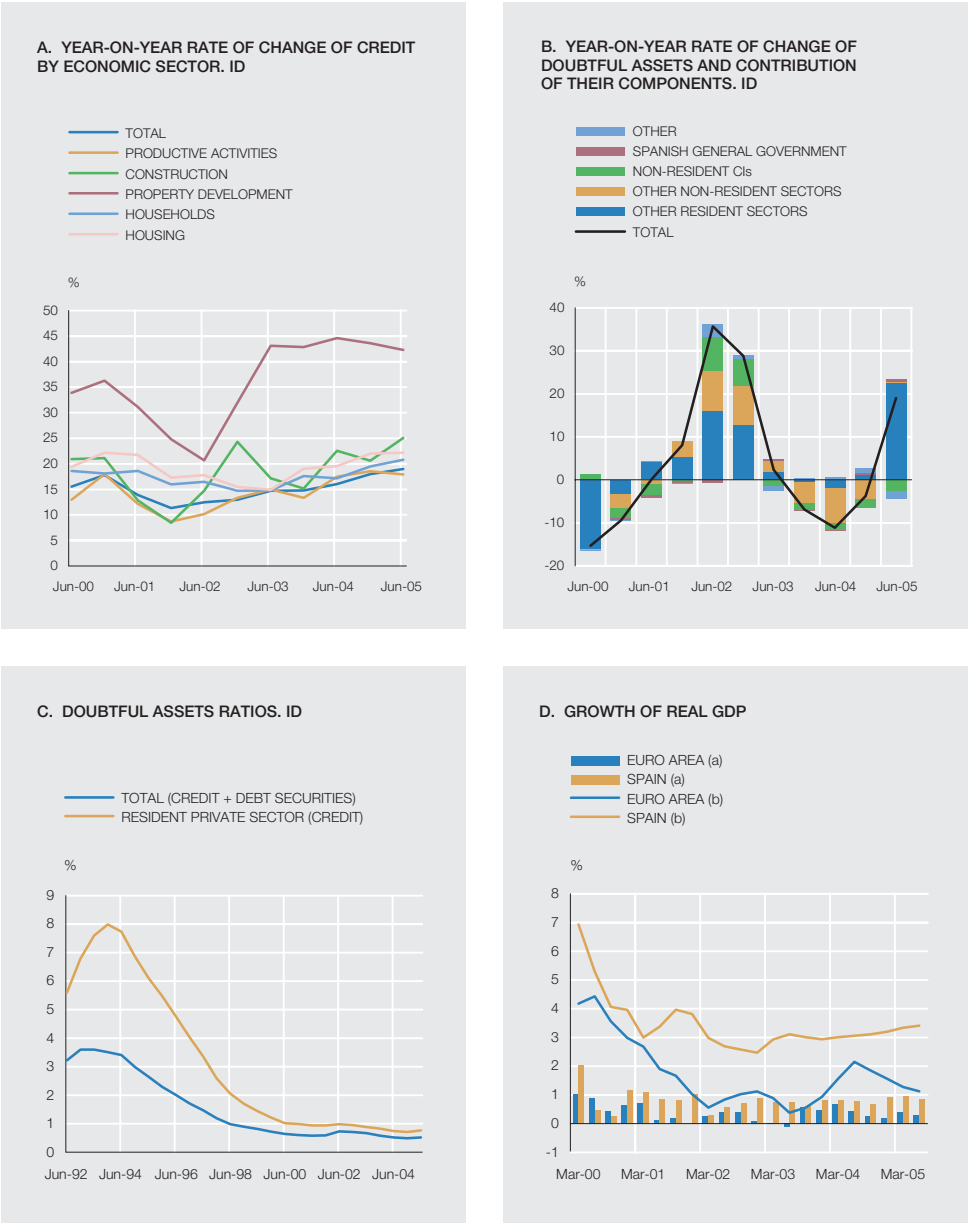
This means that caution is required in interpreting the June 2005 credit growth figures. Nonetheless, for business in Spain the trends noted in the last FSR can be seen to continue. First, total credit to firms and households again quickened owing to the greater buoyancy of financing to households in the form of house purchase loans and consumer credit. Credit growth to firms remained unchanged at levels near those of June 2004, due partly to a certain slowdown in the growth of credit to property developers, which, however, continued at year-on-year rates exceeding 40% (Chart I.5A)[2].

CBE 4/2004 also had a significant impact on the performance of doubtful assets in individual balance sheets, as may be expected. The new accounting rules tighten the transaction carryover effect of the previous accounting rules, so that now as soon as one payment becomes three months past-due the whole outstanding amount of the transaction must be classified as a doubtful asset. Until May this year only the amount of the instalments three months past-due was classified as doubtful, so long as their amount did not exceed 25% of the outstanding balance of the transaction; as soon as it did, all the transaction was recorded as doubtful. If no instalments on a transaction were paid for 12 months, the whole outstanding amount was recorded as doubtful. Hence the new accounting rules accelerate the recognition of doubtful assets and their entry into force in June 2005 should produce a significant jump in the amount

2. Box I.2 analyses the recent appearance of new credit products and their implications for financial stability.

CREDIT AND DOUBTFUL ASSETS RATIOS CHART I.5

Deposit institutions. ID



SOURCE: Banco de España.

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

of this item. This jump will be larger in long-term, large-amount transactions, e.g. past-due mortgage loans, the entire outstanding amount of which must now be recognised as doubtful after three months, instead of after one year.

Total *doubtful assets,* which on individual data had been flat or declining slightly since the beginning of 2005, grew by 19% year-on-year in June (Chart I.5B). The increase was even greater in doubtful assets associated with credit to the resident private sector (firms and households), due to the accounting effect mentioned in the previous paragraph. Given the different characteristics still seen in the credit portfolios of commercial banks, savings banks and credit co-operatives, the growth of doubtful assets, particularly those vis-à-vis the resident private sector, was greater in savings banks and credit co-operatives than in commercial banks.

NEW BANKING PRODUCTS. SOME IMPLICATIONS

BOX I.2

Technological development, progress in risk management techniques and the parallel development of credit derivatives markets have made it possible to expand the range of products offered by credit institutions. The greater variety of banking products, apart from representing new channels in which institutions compete, has improved and facilitated access to credit by the private sector. However, some of these products require careful analysis from the standpoint of financial stability.

Institutions have recently launched a *wide variety of loans* and lines of credit, particularly in the case of mortgage credit. Nowadays there is a broad range of products that allow bank customers to choose how to spread the debt burden over the life of the loan. Thus customers can choose not only the type of interest rate (fixed, variable or a combination of the two) and the repayment period which, in some cases, can be as much as 40 years, but also the system of periodic instalments (fixed or variable), adjusting the repayment period over the life of the loan, independently of the type of interest rate chosen. Also, institutions offer credit arrangements in which the customer can opt for a grace period of up to five years in the case of mortgages, and can defer up to 30% of the loan principal until the loan maturity date. In some cases the customer is offered mortgage financing of up to 100% of the value of the dwelling.

The diverse possibilities offered have unquestionably brought mortgage credit more within the reach of people who have clear prospects that their ability to pay will increase with time, but who, when the loan is granted or temporarily during the life of the loan, may have some difficulty in coping with the debt burden (e.g. young people).

Moreover, in the case of mortgage credit, apart from certain multipurpose lines of mortgage credit the first drawdown of which must be used for house purchase but subsequent drawdowns of which can under certain conditions be used for other purposes, there have recently appeared products that enable households to borrow against the appreciation of their property wealth. Some institutions offer credit accounts with services similar to those of a current account that allow the appreciation of the holder's property wealth to be used directly as security to obtain cash.

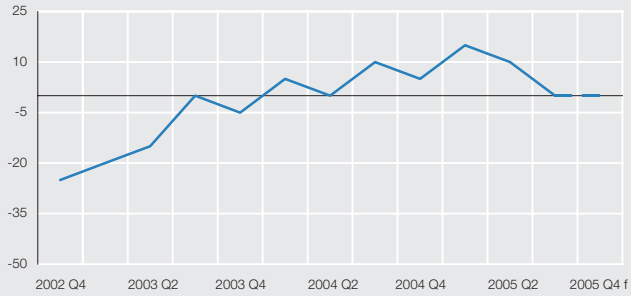
Insofar as the new range of credit products is providing readier credit to people previously more constrained by more rigid credit terms, the new products may, to some extent and in conjunction with the traditional determinants of credit demand, be helping to maintain the high bank credit growth rates seen in recent years.

The bank lending survey conducted in the euro area[1] shows an expansionary path for Spain recently, particularly in financing to households (Charts A, B and C)[2]. Demand is also showing expansionary behaviour (Charts B, D and F).

1. In the Eurosystem bank lending survey, sampled institutions are asked about the changes each quarter in their new-loan approval criteria and in the demand for those loans, distinguishing between three types of credit. The institutions are also asked about their expectations for the following three months. **2.** The individual results are presented in the chart, aggregated in the form of a dissemination indicator. A positive (negative) value indicates net expansionary (contractionary) behaviour on either the supply side or the demand side of each type of credit.

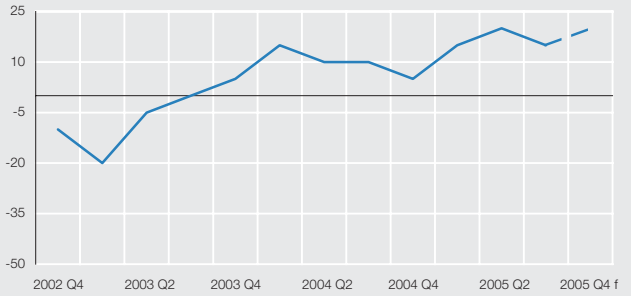
CREDIT TO NON-FINANCIAL CORPORATIONS. CHANGE IN SUPPLY

CHART A



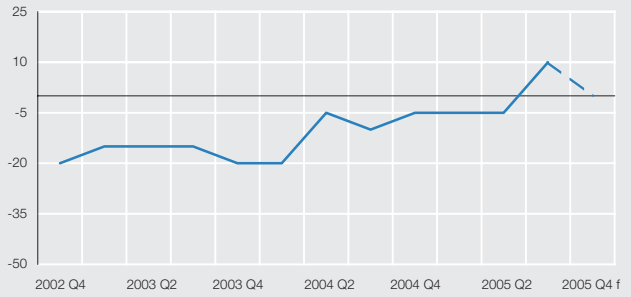
CREDIT TO NON-FINANCIAL CORPORATIONS. CHANGE IN DEMAND

CHART B



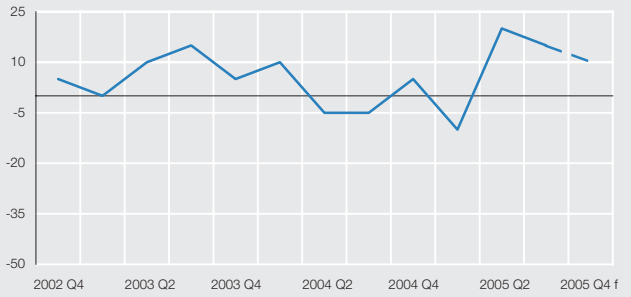
HOUSE PURCHASE CREDIT TO HOUSEHOLDS. CHANGE IN SUPPLY

CHART C

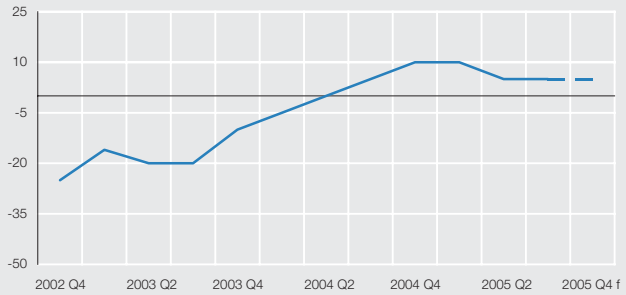


HOUSE PURCHASE CREDIT TO HOUSEHOLDS. CHANGE IN DEMAND

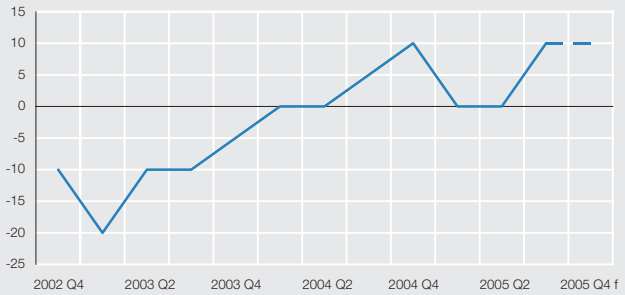
CHART D



CONSUMER AND OTHER CREDIT TO HOUSEHOLDS. CHANGE IN SUPPLY CHART E



CONSUMER AND OTHER CREDIT TO HOUSEHOLDS. CHANGE IN DEMAND CHART F



SOURCE: Banco de España.

NOTE: Indicator = % of institutions reporting a considerable increase × 1 + % of institutions reporting a certain increase × ½ – % institutions reporting a certain decrease × ½ – % of institutions reporting a considerable decrease × 1. The last observation in each chart is the forecast by the surveyed institutions for 2005 Q4.

The greater diversity of credit products may contribute to raising the efficiency of resource allocation in the long term and enable risk to be better distributed, which would in principle enhance social welfare. However, in the short and medium term, the existence of asymmetric information means that institutions, customers and regulators will need an extended learning period to fully understand the workings and the risks of these new products, with the consequent costs. Further, it should be pointed out that easier access to credit should be based on appropriate risk monitoring and control by credit institutions and on a sound knowledge by bank customers of the risks associated with the various products. Otherwise, the diversity of products may end up affecting financial stability and wiping out the gains accruing to the public from a more complete credit market.

The easier access of households to credit and their greater ability to mobilise their property wealth may produce an excessive concentration of risk in certain income segments and, therefore, make banks more sensitive to economic shocks. This effect may be magnified if private sector spending decisions become more sensitive to interest rates and to wealth.

Despite the significant increase in doubtful assets, the impact on *doubtful asset ratios* was diluted by the return to the balance sheet of a portion of the securitised assets, namely those that did not involve an effective transfer of risk by deposit institutions. Past FSRs emphasised that the transfer of credit risk depends on whether or not the deposit institution has committed itself to bearing the initial losses that may arise on securitised loans, for the amount of that coverage of the expected actual loss on the securitised portfolio. Since these commitments were customary and the coverage of losses was generous, a good part of these transactions without effective transfer of risk to third parties have to be recorded in the balance sheet under CBE 4/2004. Thus the denominator of the doubtful asset ratios has grown substantially, partly neutralising the rise in doubtful assets.

The ratio of total doubtful assets to loans and receivables (credit and fixed-income securities) based on unconsolidated data at the individual institution level stood at 0.51% in June 2005, and this ratio was 0.75% in credit to the resident private sector, representing rises of 4 bp and 7 bp, respectively, with respect to May. This increase, when viewed in a longer timeframe (Chart I.5C), is limited and relative, given the cyclical position of the Spanish economy (Chart I.5D).

The risk profile of *foreign financial assets* decreased as a result of the favourable performance of the international economy, particularly the Latin American economies where a still significant part of the foreign assets of Spanish institutions is concentrated, although this business is declining in relative terms. The improved credit rating of Argentine public debt contributed ad-

ditionally to bettering this risk profile. The sovereign spreads in the geographical areas where Spanish banks have a significant presence also point to a favourable trend in credit risk.

I.2 Credit risk

I.2.1 IMPACT OF THE MACROECONOMIC BACKGROUND

a. Spain and the euro area

Between March and June, economic activity in the *euro area* continued to show signs of weakness, making a very moderate contribution to domestic demand despite the favourable financial conditions. Year-on-year real GDP growth decreased by 0.2 pp to 1.1%, while quarter-on-quarter growth was down by 0.3% (Chart I.5D). By contrast, the *Spanish economy* continued to show considerable buoyancy, mainly due to the strength of domestic spending. Thus, in the same period, GDP growth under the new Spanish National Accounts with base year 2000 was 3.4% and 0.9% in year-on-year and quarter-on-quarter terms, respectively.

The favourable course of the Spanish economy must not, however, be allowed to mask the existence of both external and internal risks that threaten its dynamism at medium term. The former include global imbalances (the US current account deficit and the Asian surplus) and oil prices; among the latter are those relating to competitiveness and to the financial position of households, notably linked to house prices.

Non-financial corporations

In the first half of 2005 the gross operating profit of the corporations reporting to the Banco de España Central Balance Sheet Data Office (CBSO) grew more slowly at 5.4%, down 1.5 pp on the same period of 2004. All sectors slowed except energy, in which the profits of refining corporations improved significantly. In other energy firms and in transport, however, the opposite was true because of the higher prices of oil derivatives. On the other hand, despite the increase in financial costs, derived mainly from increased recourse to borrowing, the favourable performance of financial revenue, particularly dividends from foreign subsidiaries, meant that ordinary net profit grew at a faster rate of nearly 11%. Moreover, the sharp increase in extraordinary income and the lower provisioning led net profit to rise at a notable pace of nearly 32%. Analysts' expectations as to the growth of listed non-financial corporations' profits remained at high levels, similar to those at 2004 year-end.

The favourable performance of corporate profits meant that *profitability* ratios remained high. Both ordinary return on investment (ROA) and return on equity (ROE) increased with respect to the same period of 2004, standing at 8.2% and 12%, respectively. Furthermore, the relative steadiness of the cost of borrowed funds at 4% in the first half meant that the spread between return on investment and the average cost of borrowed funds stood at 4.2 pp for the reporting corporations as a whole, which was 0.8 pp more than in the same period of 2004.

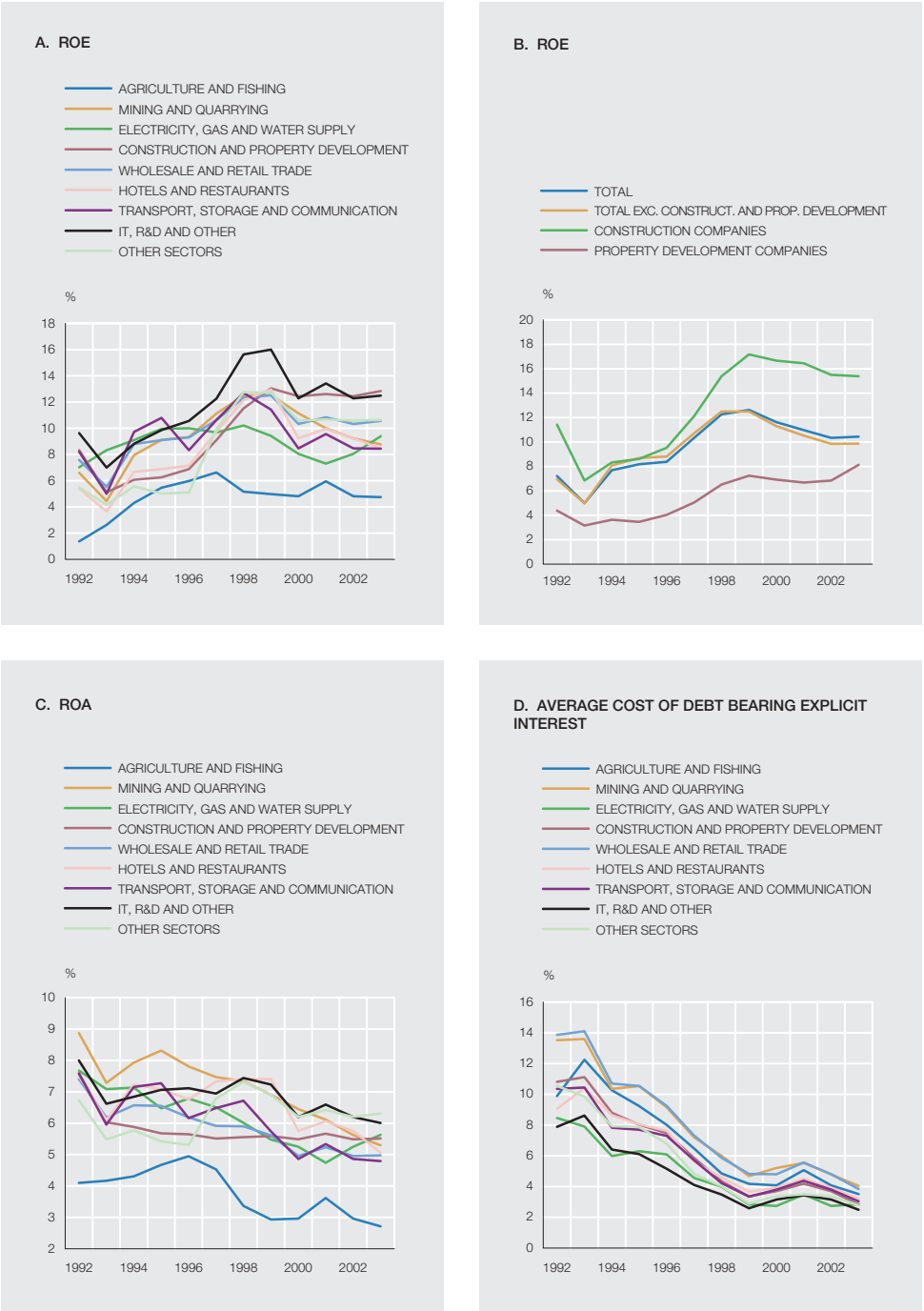
In the first half of 2005, the *debt* (credit from financial institutions and securities issues) of non-financial corporations again increased, this time at a year-on-year rate of more than 17%. As regards branches of production, the information on resident credit institutions for the first half showed the continued buoyancy of funds flowing to construction and real estate services, which grew by more than 25% and 42%, respectively, compared with the same period of 2004 (Chart I.5A). This financing led to a fresh increase in aggregate debt ratios. Despite the stable cost of borrowed funds, the interest burden edged up slightly to around 17% of gross operating profit plus financial revenue.

Despite the increase in the sector's debt and financial burden, the continuing solid financial position of corporations, along with their favourable earnings outlook, helped the credit risk premiums in derivatives markets to hold at the low levels seen so far in 2005.

According to the latest information available in the Mercantile Register, which is for 2003, non-financial corporations exhibited a solid, stable financial position evidenced by a ROE of more

PROFITABILITY AND COST OF DEBT CHART I.6

Non-financial corporations



SOURCES: Mercantile Register and Informa.

than 10% (the median for all sectors). Analysis of *sectoral differences* (Chart I.6A) shows that the agricultural sector has the lowest profitability at somewhat more than 4%, compared with a ROE exceeding 12% in the construction and property development sector and in the IT, R&D and machinery hire sector.

Given the strong growth of Spanish deposit institutions' exposure to the property sector, it is of interest to analyse the financial position of construction and property development firms. The ROE of these firms has remained stable in the last few years and the difference with respect to the other sectors has become progressively larger (Chart I.6B). If construction com-

panies are distinguished from property developers, the ROE of the former is seen to be significantly higher, although their profitability has followed a slightly declining trend since the end of the 1990s. The profitability of property developers has increased slightly. Hence, the overall profitability of the sector has been stable and high in recent years.

The ROA of non-financial corporations, evaluated at the median of the distribution, has trended downwards since the mid-1990s, as mentioned in the last FSR (Chart I.6C). If this behaviour is analysed by sector, declines are seen for mining and quarrying and manufacturing firms. By contrast, construction and property development firms have the most stable ROA. The sector with the highest return on assets is IT, R&D and machinery hire, with the primary sector being the least profitable. The average cost of debt followed a clearly declining trend characterised by convergence between sectors, which can be explained by the low nominal real interest rates at present (Chart I.6D).

Previous FSRs analysed the behaviour of *business and financial fragility indicators* relating to non-financial corporations as a whole that can be used to identify which corporations have the greatest economic risk and quantify their exposure to the financial sector, measured in terms of total and bank debt[3]. Insofar as the economic shocks that affect the results of non-financial corporations vary from one economic sector to another, it will be more important for these indicators to distinguish between sectors. This makes it possible to detect the more critical sectors, defined as those subject to highest business risk and/or those to which the financial sector is most highly exposed.

Charts I.7A, B and C depict the sectoral contributions to the aggregate indicators of business risk, *ex ante* financial risk and *ex post* financial risk, respectively, in Spanish non-financial corporations in the period 1992-2003. The behaviour of the aggregate indicator of business risk, defined as the probability that a non-financial corporation chosen at random from the population has a non-positive economic profit, is predominantly determined by the sectors with the highest percentages of corporations: manufacturing, mining and quarrying, wholesale and retail trade, and construction and real estate services (Chart I.7A). The performance of this indicator since 2003 shows a general improvement in the sectoral indicators of business risk.

However, across sectors there are differences in level that are relatively stable over time. The relatively more risky sectors in terms of this indicator are agriculture, livestock breeding and fishing and wholesale and retail trade, where the percentages of corporations at risk are higher than in the overall population of firms during the whole period. It is also noteworthy that, in terms of business risk, the manufacturing, mining and quarrying, and construction and real estate services sectors diverge from non-financial corporations as a whole. Whereas in the first sector, the divergence, which commenced in 2000, produced an increase in the level of risk with respect to non-financial corporations as a whole, business risk in the construction and real estate services sector decreased in relative terms since 1999, at a very favourable time in the business cycle for these firms. However, the contribution of this sector to the behaviour of the aggregate indicator has been stable in recent years due to the rise in the number of firms in the sector.

The financial risk induced by the presence of firms with high economic risk again decreased in 2002 and 2003 to stand at the lowest level in the whole period. This is indicated by the de-

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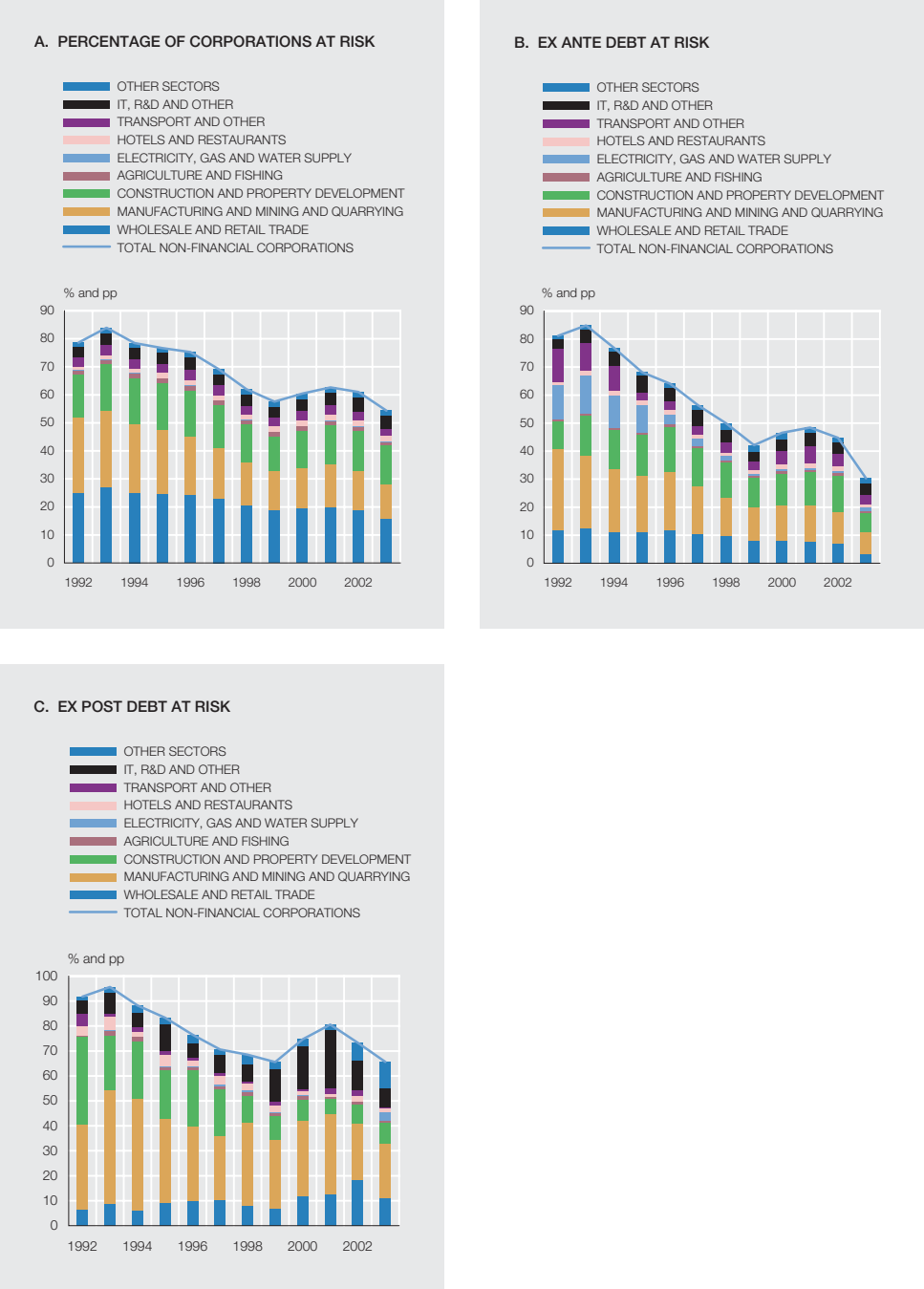
3. The indicators analysed are based on the study by S. Ruano and V. Salas: "Indicadores de riesgo basados en la information contable de las empresas, *Estabilidad Financiera,* 7, November 2004. The risk to financial system stability deriving from the fragility of non-financial corporations can be quantified through the probability that a firm may be in a situation of risk as a result of profit impairment and through the amount of bank debt concentrated in firms that are in that situation.

SECTORAL CONTRIBUTIONS TO CORPORATE AND FINANCIAL FRAGILITY INDICATORS

CHART I.7



SOURCES: Mercantile Register, Informa and Banco de España.

crease in the *ex ante* financial risk indicator, which is defined as the proportion of bank debt concentrated in the corporations comprising the highest business risk category within Spanish non-financial corporations as a whole (i.e. in the corporations whose profitability does not exceed their cost of capital), after the rise that started in 2000 and ended the downward trend of the 1990s (Chart I.7B). This improvement is the result of declines in the proportion of bank debt concentrated in the higher risk firms in nearly all sectors. Noteworthy due to the size of their contribution to the aggregate indicator's behaviour are the improvements in construction and real estate services, manufacturing, mining and quarrying, and wholesale and retail trade. With regard to the first of these sectors, mention should be made of the exceptional increase

in commercial bank debt during the period, which has made it the sector with the highest weight of bank debt and, therefore, a factor of risk if the financial position of these firms worsens.

Finally, the *ex post* indicator of debt at risk, defined as the proportion of doubtful debt concentrated in firms of high business risk (Chart I.7C), stood at more than 65% for non-financial corporations as a whole, although it has a cyclical profile similar to that of the other two business and financial risk indicators.

Although the sectoral *ex post* indicators of debt at risk are characterised by the presence of major inter-sectoral differences in level and by very volatile behaviour that prevents a stable ordering of the sectors over time from being established, the behaviour of the aggregate indicator is basically determined by the sectoral *ex post* indicators of debt at risk for the manufacturing, mining and quarrying, wholesale and retail trade, and construction and real estate services sectors, which account for the bulk of doubtful bank debt in the entire period (nearly three-quarters in 2003). Worthy of comment in this respect is the slight rise in the percentage of doubtful bank debt in construction and real estate services sector firms, which, nevertheless, continues to be relatively low (14.5%) after a sustained fall during the period analysed. Mention should also be made of the significant increase in the concentration of doubtful bank debt in wholesale and retail trade, which has gone from around 10% at the beginning of the period to levels between one-quarter and one-third in recent years.

In summary, sectoral analysis of the behaviour of indicators of *ex ante* and *ex post* business risk and financial risk reveals the presence of three notable sectors (manufacturing, wholesale and retail trade, and construction and real estate services). These sectors accounted for the highest percentages of non-financial corporations over the entire period and represented the highest risk exposures for the financial sector, as measured in terms of volume of bank debt and of doubtful bank debt. In particular, mention should be made of the growing exposure to the construction and real estate services sector, as measured both by number of firms and by bank debt. A worsening of the profitability of these firms could pose major difficulties to the institutions with larger exposures and worse selection of borrowers.

Households

The generous financial conditions continued to help sustain the expansion of household debt, which again grew at rates of around 20% in annual terms in the first half of the year. This performance was again shaped by lending for house purchases, the growth rate of which held at high levels near 24%.

These developments resulted in a further worsening of the financial pressure indicators of households. Both the debt ratio and the financial burden ratio rose again in the first half of the year. However, despite the higher debt, the net wealth of households increased further, thanks to house price appreciation, which continued at high rates.

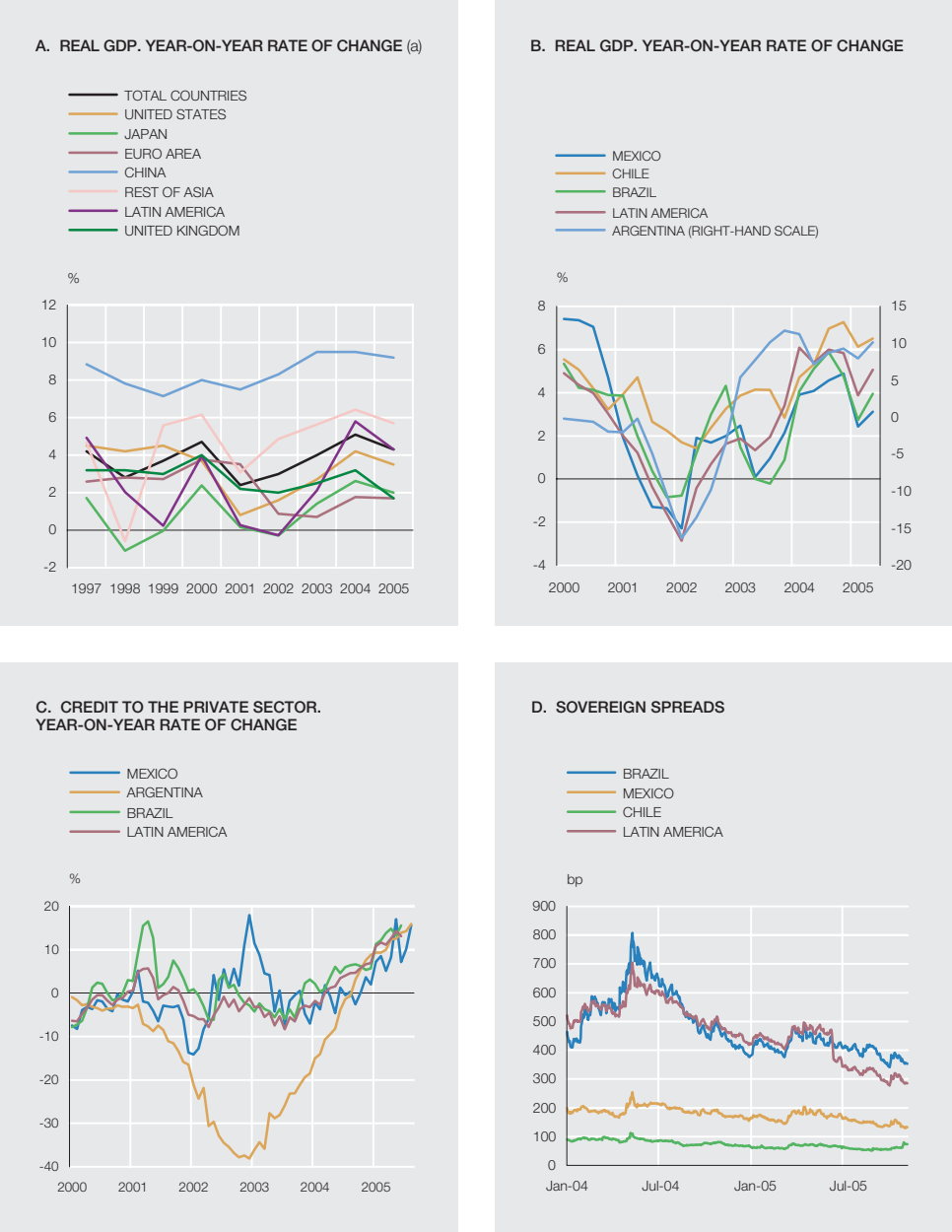
Therefore, although the aggregate financial position of the sector remained solid, the risk associated with its growing indebtedness and with house price levels remain in place.

b. Rest of the world

In the first half of 2005 the pace of activity of the external environment of the euro area was again strong (Chart I.8A), albeit lower than in 2004, and, for the time being, free from any inflationary pressure stemming from the high oil prices. The strong and persistent rise in oil prices in the year took them to USD 67 per barrel *(Brent)* in early September, compared with USD 40 per barrel at the beginning of the year, against a background of high demand and scant capacity to step up supply.

GDP, CREDIT GROWTH AND SOVEREIGN SPREADS

CHART I.8



SOURCES: FSR and Datastream.

a. Latest estimate: IMF (total countries and rest of Asia), ECB (euro area) and in-house calculation.

The favourable macroeconomic performance was basically due to the sustained growth of the US and the Asian economies, and to Japan following this trend from 2005 Q1, after the sharp slowdown in the second half of 2004 (Chart I.8A). This pattern of world growth had, however, certain adverse implications, since it helped to aggravate global imbalances, particularly the US current account deficit and the Asian surplus, especially that of China, where international reserves continue to accumulate. This has raised the vulnerability of the global economy to a sudden correction of these imbalances. Another significant risk to the smooth performance of the international economy lies in the possible prolongation, and even heightening, of upward pressures on oil prices, particularly if there is a significant transfer to wages and prices.

In the *United States,* gross domestic product grew in Q1 and Q2 at an annualised quarter-on-quarter rate of 3.3% (3.6% in year-on-year terms), with significant contributions from private

consumption and business investment. The external sector made a positive, albeit moderate, contribution in Q2 after years of negative contributions. The demand and employment data available for 2005 Q3 were also favourable, and this was reflected in the GDP growth of 3.8% in annualised quarter-on-quarter terms according to the preliminary estimates published. The current account deficit of 6.3% of GDP in Q2 was slightly lower than in Q1, but with an additional deterioration in the trade balance. The consumer price index posted a 1.2% monthly increase in September, taking growth to 4.7% year-on-year, basically due to the sharp increase in energy prices, so it scarcely passed through to underlying inflation, which remained low (2.2% in September).

Japan's GDP grew by 1.4% and 2.1% year-on-year in 2005 Q1 and Q2, respectively, which represented a sharp pick-up with respect to 2004 Q4. The main contributions to growth came from domestic demand, in which the pace of private consumption and, particularly, non-residential fixed capital formation quickened, as against a slightly negative contribution from the external sector. These data signify a reversal of the slowdown besetting the Japanese economy in the second half of 2004 and they led to an upward revision of the forecasts for 2005. The GDP deflator and the consumer price indices again posted negative growth rates.

The *United Kingdom* grew by 1.6% year-on-year in Q3, against 1.5% in Q2, confirming the sluggish activity apparent in the last few quarters. A notable development was the lower contribution of domestic demand, more due to private consumption that to investment, despite the vigorous rise in exports which resulted in a moderate contribution to growth by the external sector. This weak consumption seems to be related to the sharp slowdown in house prices in recent months. The Bank of England cut its official interest rates by 25 bp to 4.5% in August.

In *China,* GDP growth in the first three quarters of the year stood at 9.4% and 9.5% (year-on-year rate), respectively, these figures being very similar to those recorded at 2004 year-end, while the trade surplus tended to widen. In Q1 the current account surplus reached a high of USD 67 billion, equal to 8.1% of GDP. There was a mild revaluation of the renmimbi on 21 July and at the same time the exchange rate regime was changed such that the fixed exchange rate of the renmimbi against the dollar was replaced by a basket of currencies. In addition, diverse measures were announced to strengthen the market's role in determining the exchange rate. For the time being, the renmimbi is holding very steady around the level announced after the revaluation of 8.11 yuan per dollar.

In Q1 activity in *Latin America* slowed in all economies with respect to 2004, recovering again in Q2. The growth rate of the seven main economies taken as a whole went from 5.9% in 2004 Q4 to 4% in 2005 Q1 and to 5.1% in 2005 Q2 (Chart I.8B). This rate, however, masks certain divergences in the cyclical behaviour of the countries: on the one hand, the growth of Argentina, Brazil, Colombia and Venezuela revived, and on the other, that of Chile, Peru and, to a greater extent, Mexico slowed.

The momentum of *domestic demand* moderated in Latin America, although growth stayed above 5% in the first half of 2005. Private consumption remained robust, with exceptions like Mexico, underpinned by brisk job creation and the recovery of credit to the private sector. Investment was again the component of domestic demand with the highest growth, underpinned by generous financial conditions, the continuing favourable economic outlook, high capacity utilisation and strong external behaviour. It should be noted that exports performed favourably despite a certain slowdown in the growth of world trade and the appreciation of real effective exchange rates in most countries. This buoyancy meant that the region's trade surplus persisted and even widened, standing above 4% of GDP in the first half of the year, which,

together with the continued growth of remittances, kept the current account surplus above 1% of GDP for the regional aggregate.

Prices moved favourably in most countries, particularly if account is taken of the continuous increase in energy prices and of the now positive production gaps in many countries. The year-on-year inflation rate of the regional aggregate fell to 5.8% in September 2005, against 6.5% at 2004 year-end. The reasons for this seem to be the improved anti-inflationary credibility in most countries and the appreciation of Latin American currencies. Price behaviour was most worrying in Argentina, where the consumer price index accelerated to almost 10%. The general moderation in inflationary pressure meant that the upturn in interest rates in Brazil and Mexico came to an end halfway through the year and that rates even started to fall in 2005 Q3. By contrast, in Chile interest rates rose more quickly, although remaining at low levels. In Argentina interbank rates have risen notably in the last few months.

The continuing economic growth and the containment of inflationary pressure in most countries enabled the further acceleration of *credit* growth in real terms in the region, which picked up from year-on-year rates of 7% at 2004 year-end to almost 13% at the end of the first half of 2005 (Chart I.8C). Most notable was the acceleration of total credit in Brazil and of mortgage credit in Mexico. Despite this, in Mexico total credit in real terms still represents only 57.5% of that at 1994 year-end, just before the tequila crisis.

Sovereign spreads narrowed further in 2005 against a backdrop of low long-term interest rates in the US and abundant global liquidity (Chart I.8D). This reduced the regional EMBI index to lows of less than 300 bp at the end of October, against 420 bp at the beginning of the year. Particularly notable were the sovereign spread reductions in Peru, Colombia and Uruguay. The sovereign credit ratings changed minimally during the half-year, with the notable exception of Argentina, the rating of which improved substantially after its debt restructuring.

I.2.2 IMPACT OF INSTITUTIONS' CREDIT POLICY

Credit growth

Credit to the resident private sector in business in Spain, after allowing for the effect of the securitised assets returned to the balance sheet because credit risk was not substantially transferred[4], picked up again in the first half of 2005 and in June reached a rate of 20.1% for deposit institutions as a whole[5]. Mortgage lending grew at 25.2%, against 13.6% for other unsecured loans (Chart I.9A). The analysis of commercial and savings banks separately gives similar results, although savings banks grew somewhat more than commercial banks in secured transactions (26.6% against 23.6%, respectively) and the opposite was true of other transactions (12.7% against 14.7%). The expansion of financing related to the property sector (both to households for house purchase and to construction companies and, in particular, to property developers) explains this different behaviour. The last few FSRs have paid special attention to this circumstance and to the risk it entails for institutions. So far no change of trend in deposit institutions' exposure to the property sector has been observed.

As a result of the difference in credit growth across sectors, the relative weight of financing for house purchases and to property developers continued to grow in the credit portfolios of commercial and savings banks (Chart I.9B). In the case of savings banks, 65.8% of credit to firms

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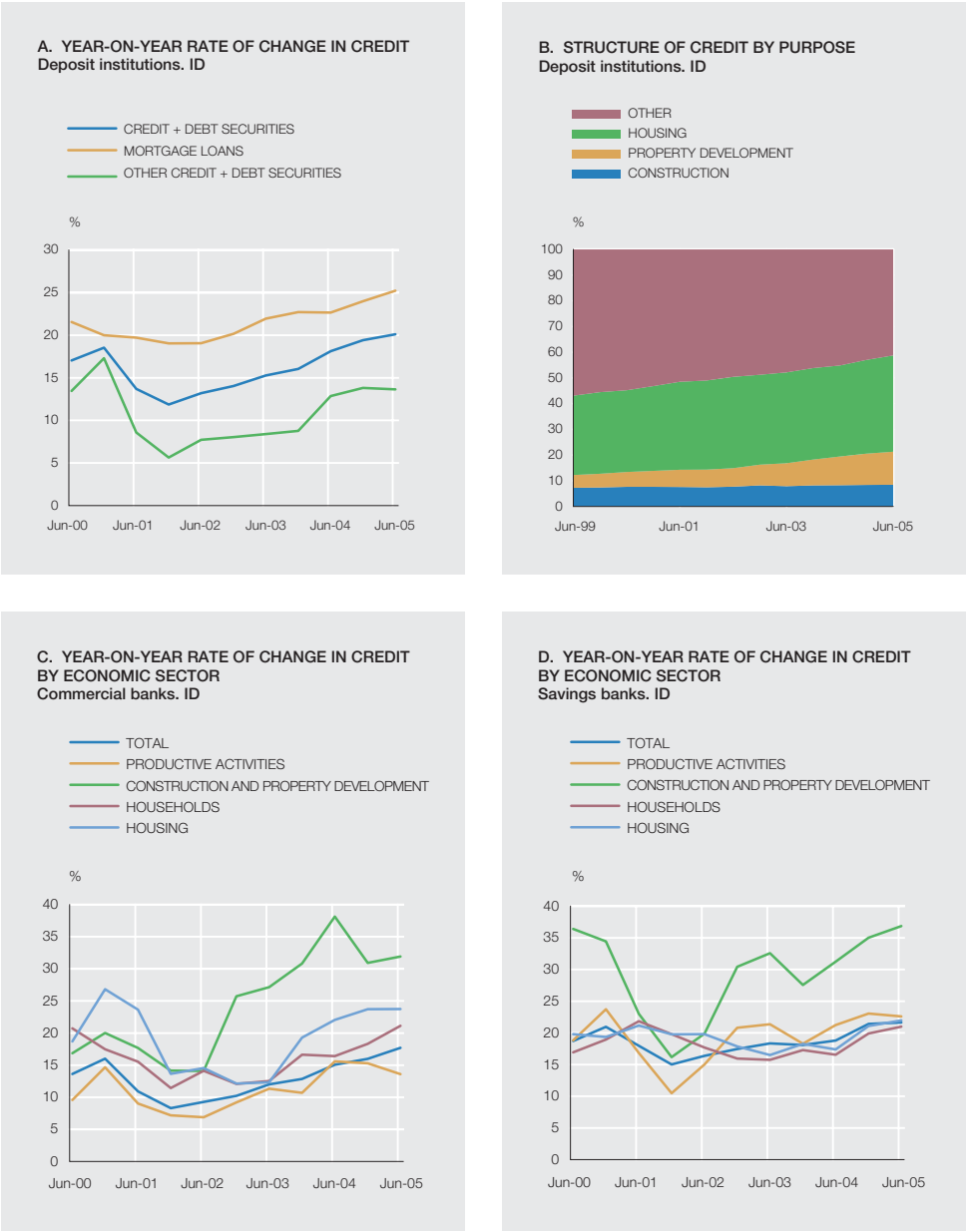
4. CBE 4/2004 requires institutions to provide information on securitised assets retained on the balance sheet. Assuming that the structure of securitised assets on and off the balance sheet has remained relatively stable in the last few years (i.e. the risk transferred and retained has not changed significantly), a continuous series of rates of change of credit to the private sector can be obtained. Note that the credit information comes from confidential balance sheets and, in particular, is based on the carrying amounts of transactions before any valuation adjustments. **5.** Working Paper 0531 of the Banco de España entitled *Credit cycles, credit risk, and prudential regulation* reports very robust empirical evidence on the easing of credit policies (quality standards in credit approval and security required) in phases of sustained economic growth and strong credit expansion.

CREDIT TO THE RESIDENT PRIVATE SECTOR CHART I.9

Business in Spain. ID



SOURCE: Banco de España.

and households is related to the property sector, whereas in commercial banks the proportion is 52.2%. In terms of contribution to the growth rate of total credit, three-quarters is accounted for by this type of transaction, with nearly 80% of the contribution in savings banks. In general, savings banks show more buoyancy than commercial banks in corporate credit, which shows up in additional gains in their market share (Chart I.9C and D).

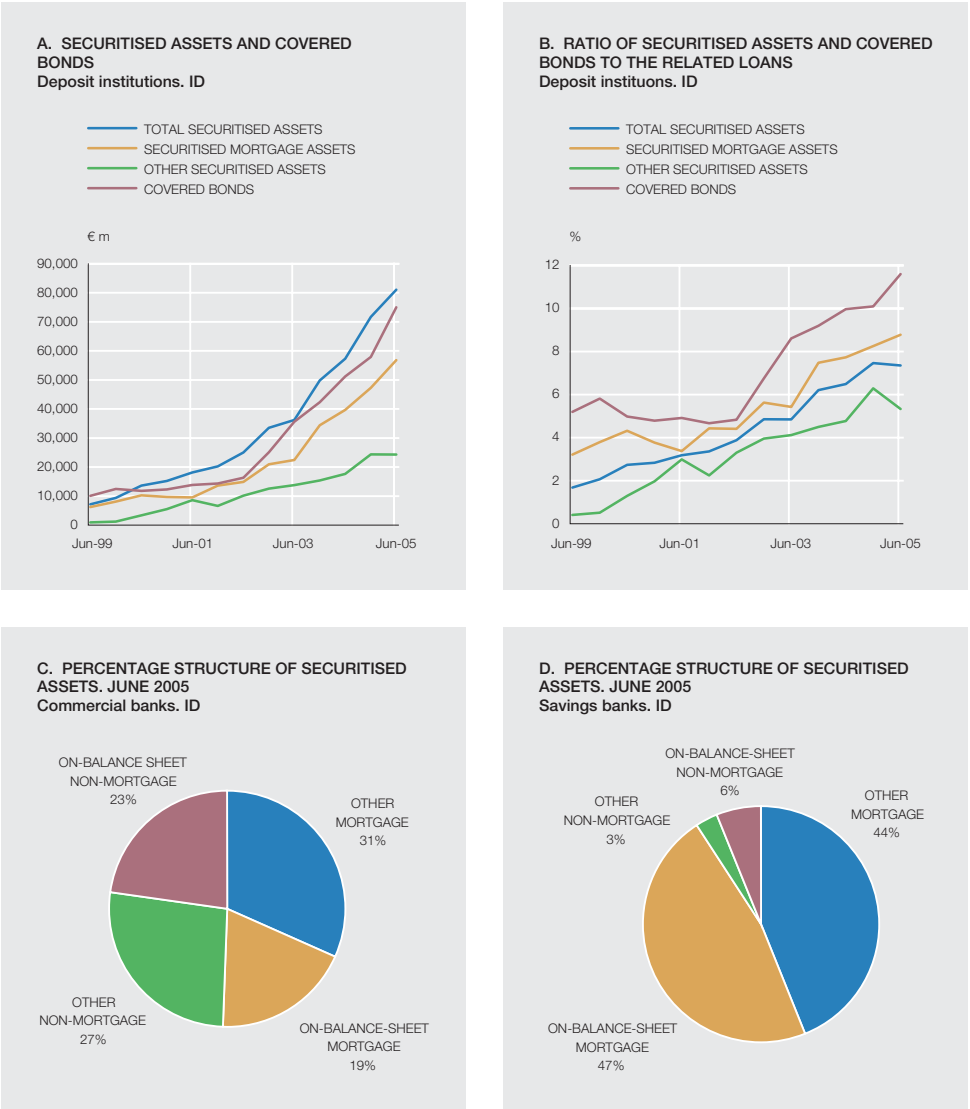
Securitisation

As was to be expected, the changes in the accounting Circular do not seem to have had a significant impact on the volume of assets securitised by Spanish deposit institutions, which have continued to rise up to June 2005 (Chart I.10A). Similarly, covered bonds continued to be issued at a brisk pace, particularly by commercial banks[6]. The process of asset securitisation in the broad sense of the term, i.e. including covered bonds, is at present primarily a response

6. Box I.3 analyses the role of covered bonds in mortgage securitisation in Spain.

SECURITISATION CHART I.10

Deposit institutions, commercial banks and savings banks. ID



SOURCE: Banco de España.

to the need for liquidity to continue financing the strong growth of lending and, to a much lesser extent, to the regulatory (accounting and capital requirements) framework.

The securitisation of assets by Spanish deposit institutions has grown significantly in the last few years and total securitised assets now represent 7.4% of loans and receivables (Chart I.10B). For mortgage assets this percentage is 8.8%. If the relative weight of covered bonds is added, the figure is 20.4%, i.e. somewhat more than one-fifth of mortgage assets have been securitised, either through covered bonds or other means that may or may not involve derecognition, depending on whether credit risk is transferred.

On June 2005 data, somewhat less than half of securitised assets are on the balance sheet. That is to say that the application of CBE 4/2004 meant that a substantial part of securitised assets returned to the balance sheet because of non-transfer of risk[7]. On-balance sheet secu-

7. Footnote 4 explains how to adjust for this impact in order to calculate rates of change in credit on a comparable basis with prior periods.

THE ROLE OF COVERED BONDS IN MORTGAGE SECURITISATION

BOX I.3

Since the mid-1990s, financing to the private sector by credit institutions has grown more rapidly than the funds received by institutions from this sector via traditional deposits. In this framework, and spurred by the development of an increasingly flexible regulatory framework, institutions have made use of asset securitisation to obtain financing and to manage their liquidity.

The first steps in securitisation in Spain date from 1981 and the enactment of the mortgage market law (Law 2/1981 on mortgage market reform). This law permitted mortgage credit granted by credit institutions to be financed by the issuance of different types of mortgage securities, of which only covered bonds and collateralised mortgage bonds were developed.

Subsequently, the creation and regulation in 1992[1] of vehicles known as mortgage securitisation SPVs made it possible for credit institutions to engage in so-called off-balance-sheet securitisation[2] through the transfer of collateralised mortgage bonds to those funds, which in turn were authorised to issue bonds using the collateralised mortgage bonds as security. However, it was not until 1998[3], with the regulation and creation of asset securitisation SPVs authorised to issue bonds secured by any type of financial instrument issued by credit institutions or by firms, that securitisation began to grow strongly in Spain, with credit institutions playing a leading role.

The securitisation of covered bonds (issued by credit institutions and securitised by asset securitisation SPVs) has been one of the driving forces of the growing securitisation activity of credit institutions. The securitisation of covered bonds has followed an upward trend and has enabled, for example, small savings banks with highly geographically localised businesses and without individual access to bond issuance at arm's-length prices, to form pools of securitised covered bonds through asset securitisation SPVs.

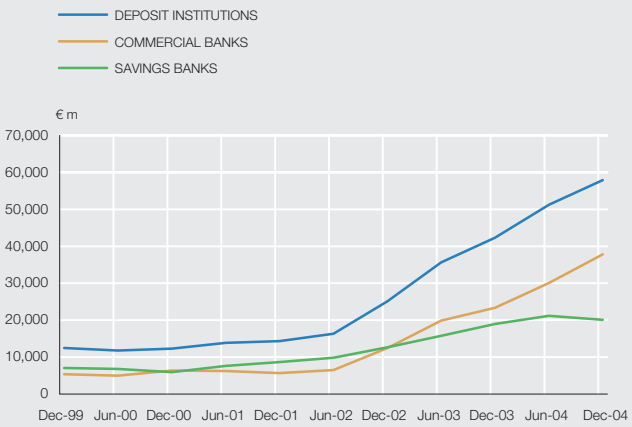
The mortgage loans used as security for covered bonds and collateralised mortgage bonds must have certain characteristics stipulated in the 1981 mortgage market law: a) the borrower must hold full title to the mortgage asset being financed and the mortgage taken out must be the first one; b) the mortgage loan must not be more than 80% (in the case of house purchase) or 70% (in the case of other real estate investment) of the value of the mortgaged asset; c) the mortgaged asset must be valued by an appraisal company (under the supervision of the Banco de España); d) the value of the covered bond and/or collateralised mortgage bond issue may not exceed 90% of the outstanding balance of the mortgage loans (excluding, in the case of covered bonds, those used as security for other types of collateralised mortgage bonds issued). The covered bonds that an institution can issue are secured by the total of the mortgage credit portfolio that meets the aforementioned requirements, whereas issues of collateralised and other mortgage bonds are linked to a specific set of mortgage loans.

Covered bonds are a very flexible financing instrument for institutions and they have clear advantages. First, the maturity of the covered loans issued by an institution need not coincide with the maturity of

1. Law 19/1992 on real estate investment companies and mutual funds and on mortgage securitisation special purpose vehicles. 2. Spanish fondos de titulización are similar to securitisation special purpose vehicles (securitisation SPVs), but there are certain legal differences. The 1992 law allows collateralised mortgage bonds issued by credit institutions to be transferred to mortgage securitisation SPVs, which transform them into standard, homogenous bonds suitable for trading on organised markets. The maturity of the collateralised mortgage bonds must be the same as that of the associated mortgage loan. Mortgage securitisation SPVs are completely separate from the financial institution that granted the mortgage loans underpinning the transaction and are not legal entities, although they are required to have a memorandum of association. The holders of bonds issued by mortgage securitisation SPVs bear the credit risk and any prepayment risk, and cannot take any legal action against the issuers of collateralised mortgage bonds or the initial borrowers. 3. Royal Decree 926/1998.

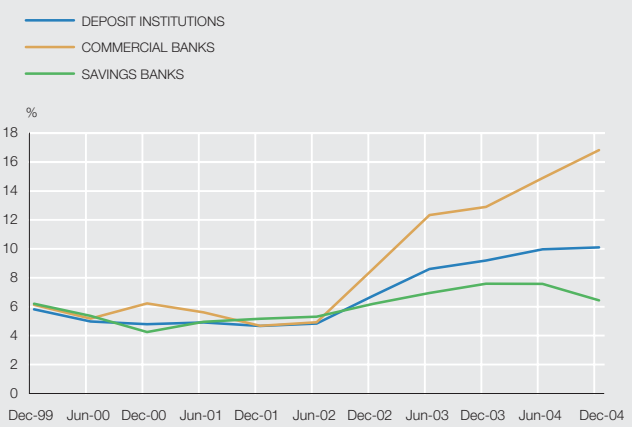
COVERED BONDS ISSUED

CHART A



SIGNIFICANCE OF COVERED BOND ISSUANCE WITH RESPECT TO MANAGED MORTGAGE CREDIT

CHART B



SOURCE: Banco de España.

the loans used as security. Covered bonds have thus been issued at short term (e.g. three years) and long term (twenty years), with ten years being the most representative maturity. Also, given their high credit quality, covered bonds are a cheaper means of attracting deposits than other types of securities transactions. Moreover, they can be used as security (List 1 of the ESCB) in monetary policy operations in the euro area.

At present the Spanish covered bonds market is one of the most rapidly growing mortgage securities markets in the EU. In 2004 the volume of covered bonds issued by financial and monetary institutions amounted to €19.2 billion (Chart A) and the outstanding balance of bank and savings bank covered bonds represented 16.8% and 6.4%, respectively, of the total mortgage credit managed by these two groups of institutions (Chart B).

In July 2005, MTS, the European market leader in fixed-income securities trading inaugurated a trading segment for covered bonds with an issue volume exceeding €1.5 billion, which is expected to increase the liquidity of this asset.

Most securitised bonds in Spain are secured by mortgage loans either directly (47.3%) or through covered bonds (35.6%). Foreign investors are the main holders of securitised bonds (62.2% in 2004), followed by financial institutions (33.7%) and the non-financial private sector (4.1%).

ritisations represent a higher percentage in savings banks (53%) than in commercial banks (41.7%). Savings banks are much more specialised in the securitisation of mortgage assets, whereas commercial banks have a much more uniform mix (Chart I.10C and D).

Risk profile of debt instruments

The new accounting Circular classifies debt instruments (securities purchased, deposits placed and credit granted, among others) in different categories: standard, substandard, doubtful due to customer arrears and for other reasons, and write-off. Standard risk is divided into six homogeneous groups or classes[8]. This risk segmentation is not very different from that in CBE 4/1991 and subsequent amendments (CBE 9/1999 and CBE 4/2000), which was the basis of the standard model for calculating the statistical provision. A substantial change, however, does arise from the inclusion, in the lowest risk category (negligible risk), of deposits at credit institutions and public debt securities. If this segment is excluded, the risk profile of debt instruments has continued to decrease in 2005 in the individual balance sheets of Spanish deposit institutions (Chart I.11A), particularly commercial banks. This trend reflects an increase in the low risk segment (mortgage credit) and medium-low risk segment (other secured credit), linked to the behaviour of credit for house purchases and for construction and property development (Chart I.11B).

The classification of debt instruments applies also to balance sheets consolidated under CBE 4/2004, which enables the risk profile to be calculated for the whole group of credit institutions. If the lowest risk category is omitted, the level and structure of standard risk is very similar in individual and consolidated reporting (Chart I.11C). Considering standard risk exposures as a whole, it can be seen that, at consolidated level, commercial banks have a higher proportion of their portfolio in the negligible risk category and in the three highest risk groups (Chart I.11D). By contrast, savings banks are more specialised in the intermediate risk segments (secured transactions).

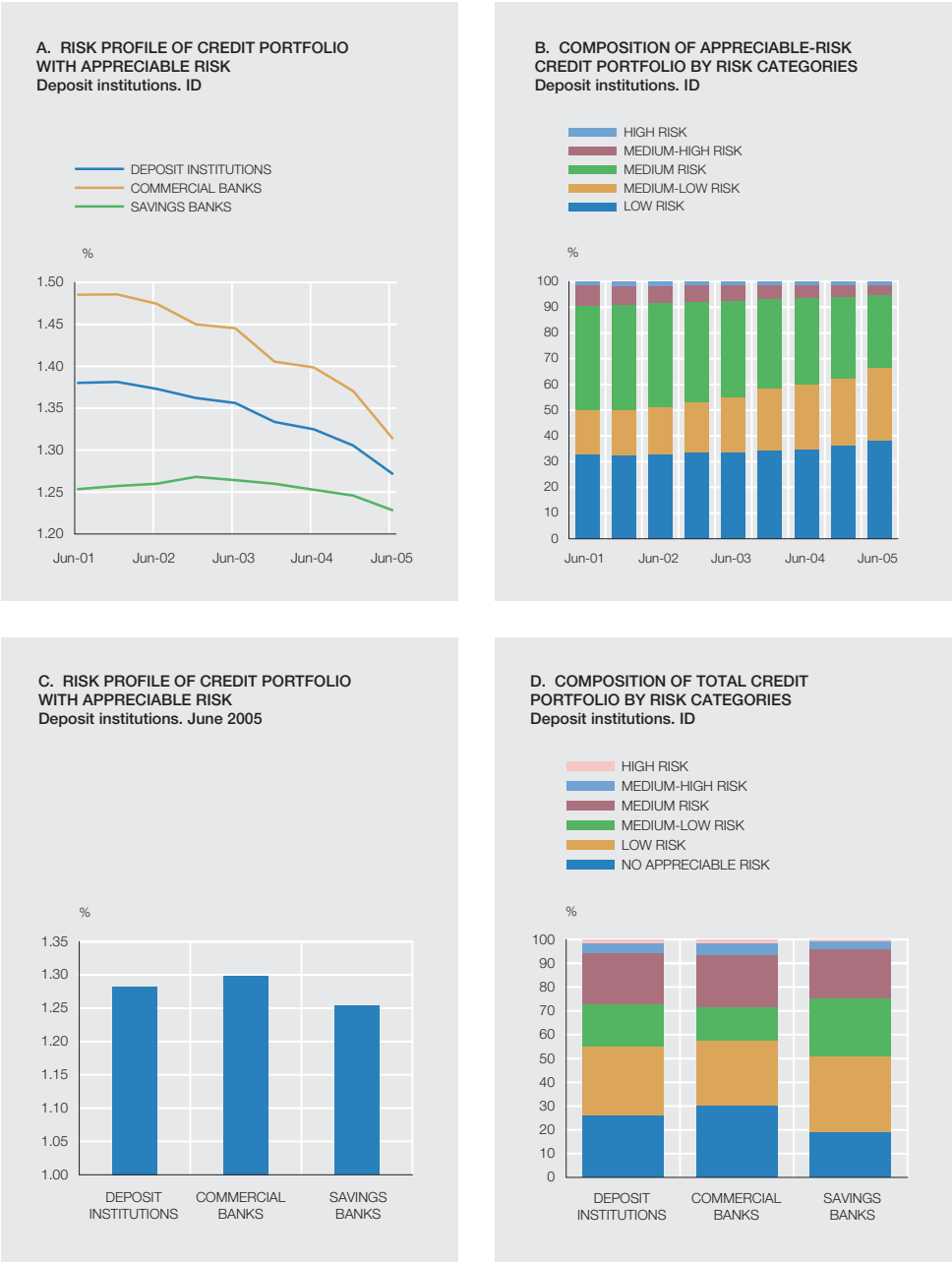
Doubtful assets

The changes in accounting rules determined the behaviour of doubtful assets and of doubtful asset ratios in June 2005, as noted in the introduction. Thus, compared with the fall in total doubtful assets from mid-2003 to 2004 year-end and no change, in year-on-year terms, from January to May 2005, there was a very significant rise in June. The behaviour of doubtful assets in recent years has been closely linked to that of commercial banks and, in par-

8. Negligible risk, low risk, medium-low risk, medium risk, medium-high risk and high risk. The glossary describes the content of each homogeneous risk group.

RISK PROFILE CHART I.11

Deposit institutions



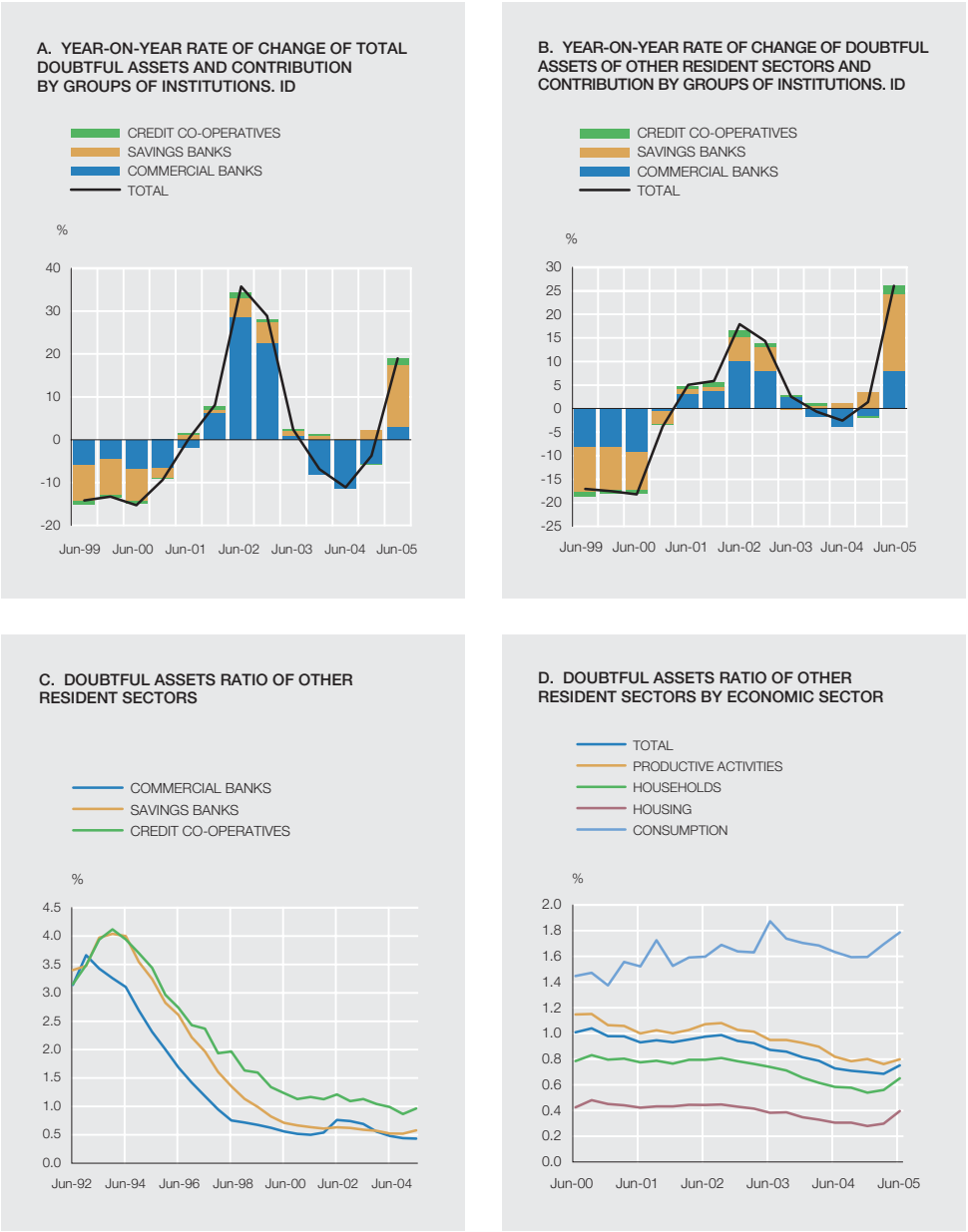
SOURCE: Banco de España.

ticular, to that of loans to the non-resident sector (Chart I.12A). In 2005 a good part of the rise in doubtful assets reflects the performance of savings banks and, in particular, the growth in June 2005. This rise can be explained by the greater weight of their mortgage portfolio in total financing to other resident sectors, and hence of doubtful mortgage assets, which in principle are expected to be more affected by the accounting change (Chart I.12A and B).

Doubtful assets ratios rose in June 2005, more so in savings banks and credit co-operatives than in commercial banks, at the individual institution level (Chart I.12C). They are, however, still very close to the lows for the last twenty years. Sectoral analysis also showed an increase in doubtful assets ratios, attributable to the accounting change (Chart I.12D). As was expect-

DOUBTFUL ASSETS AND DOUBTFUL ASSETS RATIOS CHART I.12

Deposit institutions. ID



SOURCE: Banco de España.

ed, the largest relative increase in the ratio was in financing to households for house purchases and the smallest was in financing to firms. Within the latter, agriculture, wholesale and retail trade, hotels and restaurants, and transport were the sectors with the largest increases. Once again, despite their growth, doubtful assets ratios were at very low levels with a long time horizon, in line with the cyclical position of the Spanish economy and the financial situation of firms and households. Finally, the dispersion of the doubtful assets ratios of credit to the private sector in June 2005 is practically the same as in June 2004, with a slight shift, in number of institutions (twelve) and in percentage of credit (around 5%), from the bracket below 0.5% to the bracket between 0.5% and 1%.

The doubtful assets ratio adjusted for write-offs continued to fall for deposit institutions as a whole, albeit with different behaviour in commercial banks (a further decline) and in savings banks and credit co-operatives (a slight rise), tracking the path of doubtful assets.

Probability of default

The information in the Central Credit Register (CCR) can be used to monitor the probability of default (PD, defined in this case as the ratio of the number of doubtful transactions to the total transactions granted)[9] of Spanish credit institutions. The analysis of PD is fundamental in monitoring the stability of any financial system. The CCR not only informs about the credit quality of transactions granted by credit institutions, but also contains other items such as the type of borrower (firm or legal person, as opposed to individual or natural person), the type of instrument used (trade bills, financial credit, finance lease, etc.), the maturity, the existence or not of security and the economic sector of the firms receiving bank financing. This makes it possible to analyse PD levels in some detail, and relate them to the characteristics of the financial instruments used[10].

Analysis by type of *instrument* used (Chart I.13A) shows that the PD of financial credit is higher in firms (1.63%), where it represents 80% of financing, than in households (1.05%), where it makes up 90% of credit. However, the doubtful asset ratios are substantially lower (0.8% and 0.6%, respectively), evidencing the higher credit risk on transactions of smaller amount[11]. In any event, the *ex post* credit risk, measured using doubtful asset ratios or PD, is low. Credit based on trade bills, which is used almost exclusively to provide financing to firms, is somewhat less risky in PD terms, and there is an even smaller risk on finance leases.

Most notable regarding the *maturity* of credit transactions (Chart I.13B) is the low PD and the low doubtful asset ratios of transactions with terms exceeding five years, both in households and in firms. Predominating in households are mortgage loans for house purchase, the product which has the lowest default rate and accounts for nearly 90% of financing granted by deposit institutions to households. Long-term loans to firms also have a low default rate, probably because they are subjected to more rigorous analysis in view of the long time horizon during which repayment difficulties may appear. These transactions make up nearly 40% of total financing to firms. There is no monotonic relationship between the PD and the maturity of credit to firms since, although the PD is higher at very short term (up to three months) and decreasing for maturities exceeding one year, between three months and one year the PD is lower than that of credit having a maturity between one and three years. Much the same thing occurs with doubtful assets ratios. As regards households, in credit with maturity between three months and five years the PD and doubtful assets ratios rise slightly, but they are even lower than those of very short-term credit, which has a PD of 2% but a doubtful assets ratio of nearly 6%. However, these transactions have a very low weight in the total credit portfolio of institutions.

The existence of *security* on a credit transaction is a palliative in the event of default by the customer. Theoretically, security can be used as a mechanism to align the interests of borrowers and lenders, limiting the moral hazard of the former, or it can be used by borrowers to signal their greater creditworthiness. The empirical literature, predominantly from the US, identifies a positive and significant relationship between the existence of security and borrower risk. The CCR data for June 2005 show a low PD and small doubtful assets ratios for secured transactions with individuals, particularly those with collateral covering 100% of the amount lent (Chart I.13C). These are basically mortgage transactions for house purchases, which

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9. A similar definition can be found in the paper by J. Saurina and C. Trucharte entitled "The small and medium-sized enterprises in the Spanish credit system and their treatment according to Basel II", *Journal of Financial Services Research,* Vol. 26, no 2, pp. 121-144, 2004. **10.** The analysis that follows is eminently descriptive. For a detailed study of the determinants of the PD of credit transactions granted by Spanish institutions, see the paper by G. Jiménez and J. Saurina: "Collateral, type of lender and relationship banking" published in the *Journal of Banking and Finance,* 28, pp. 2191-2212, 2004. **11.** For a detailed analysis of the role played by the size of transactions and of the borrower in the choice of bank, see the unpublished paper by J. Delgado, V. Salas and J. Saurina entitled "How do firms choose bank lenders?"

PD, DOUBTFUL ASSETS RATIO AND PERCENTAGE COMPOSITION CHART I.13

Deposit institutions, legal persons (LP) and natural persons (NP)

SOURCE: Banco de España.

a. Instrument: A-commercial credit; B-financial credit; G-fixed income securities; K-finance lease transactions; Q-loans or credits transferred to third parties.
b. Maturity: A-demand and up to 3 months; B-over 3 months and up to 1 year; C-over 1 year and up to 3 years; D-over 3 and up to 5 years; E-over 5 years; M-undefined.
c. Sectors: 1-agriculture and fishing; 2-manufacturing and mining and quarrying; 3-electricity, gas and water supply; 4-construction and property development; 5-wholesale and retail trade; 6-hotels and restaurants; 7-transport, storage and communication; 8-IT, R&D, machinery renting and other; 9-other sectors.

make up more than 80% of credit to individuals. In general, consumer credit transactions are significantly more risky in Spain, both now and for the last twenty years. By contrast, transactions with firms fully secured by collateral, which comprise more than 40% of total exposure to firms, have a PD that is 50% lower than that of unsecured or partially secured corporate financing. However, these differences are substantially smaller when it comes to doubtful assets ratios, so it is the smaller, unsecured transactions that are most prone to default. Part of the explanation lies in the strong presence of financing to construction companies and property developers, which provide transaction collateral in the form of land, buildings and dwellings in the development, construction or sale phase. However, given the continual appearance of

PD, DOUBTFUL ASSETS RATIO AND PERCENTAGE COMPOSITION CHART I.14

Commercial banks (CB) and savings banks (SB)

SOURCE: Banco de España.

a. Instrument: A-commercial credit; B-financial credit; G-fixed income securities; K-finance lease transactions; Q-loans or credits transferred to third parties.
b. Maturity: A-demand and up to 3 months; B-over 3 months and up to 1 year; C-over 1 year and up to 3 years; D-over 3 and up to 5 years; E-over 5 years; M-undefined.
c. Sectors: 1-agriculture and fishing; 2-manufacturing and mining and quarrying; 3-electricity, gas and water supply; 4-construction and property development; 5-wholesale and retail trade; 6-hotels and restaurants; 7-transport, storage and communication; 8-IT, R&D, machinery renting and other; 9-other sectors.

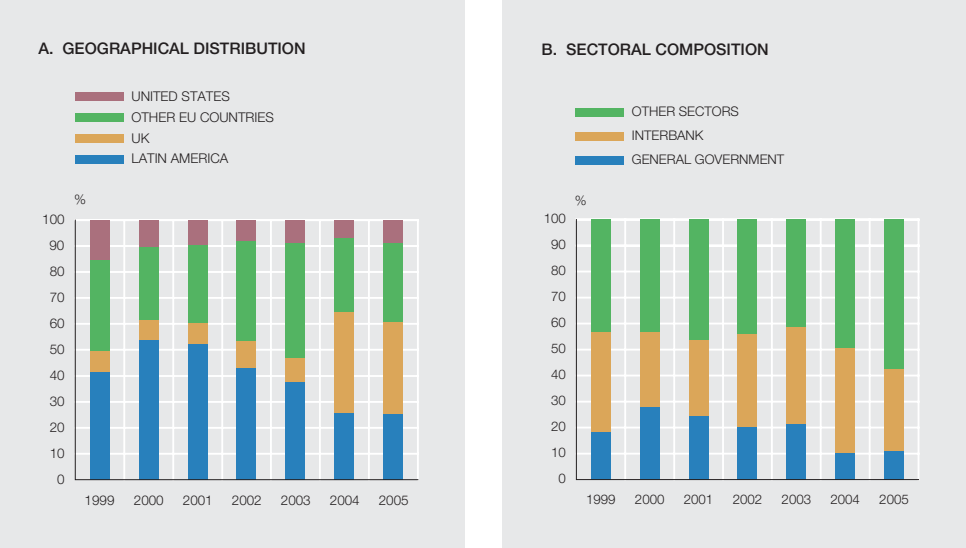
new borrowers in the CCR (creation of new firms), some of these differences may be due to the use of security as a signalling mechanism by these new borrowers[12].

Finally, the PD of financing to firms differs across *economic sectors* (Chart I.13D), being highest in hotels and restaurants and transport, and lowest in firms providing essential public services. An intermediate position is occupied by construction companies and property developers, with a PD of 1.5%, although they are the sector with by far the highest weight in financ-

12. For a detailed analysis of this subject, see the paper by G. Jiménez, V. Salas and J. Saurina entitled "Determinants of Collateral", to be published shortly in the *Journal of Financial Economics*.

FINANCIAL ASSETS ABROAD CHART I.15

Deposit institutions (a)



SOURCE: Banco de España.

a. Data relate to December of each year, except in 2005, in which they refer to March, the last month for which information was available at the date of preparation of this FSR.

ing to non-financial corporations (more than 40%) recorded in the CCR. It should be pointed out that the sectoral doubtful assets ratios are lower, in some cases significantly so (essential public services and construction and property development), indicating that the doubtful assets in these sectors are concentrated in small firms.

The *difference in specialisation* that still exists within the lending business of commercial banks and savings banks has already been noted in previous FSRs. According to CCR data as at June 2005, the greater specialisation of commercial banks in commercial credit and in finance leasing, and the greater predominance of long-term transactions in savings banks, along with a greater insistence on collateral due to their specialisation in mortgage lending to households, led to somewhat different behaviour of PD and of doubtful assets ratios depending on the type of institution (Chart I.14A, B, C and D). There is no close relationship between specialisation in a credit segment and level of credit risk. In certain types of transaction in which savings banks are more specialised than commercial banks (financial credit), the former enjoy lower PD than the latter, while in others (unsecured transactions and short-term transactions up to one-year maturity), the lower specialisation of savings banks leads to lower PD. By contrast, the lower relative presence of commercial banks in the construction and property development sector and in transactions with terms of five years or more leads to lower doubtful assets ratios that those experienced by savings banks, although the PD does not differ substantially.

Financial assets abroad

The acquisition of a large UK bank reported in the last FSR substantially increased the amount of financial assets abroad at 2004 year-end with respect to that at 2003 year-end. On data to March 2005, financial assets abroad grew by more than 8% with respect to December 2004. Their geographical and sectoral distribution also changed, since the relative weight of financial assets in Latin America decreased and the weight of exposure in Europe and, more specifically, the UK, increased. The relative weight of the private sector (households and firms) increased at the expense of interbank assets and public debt. In 2005 Q1 deposit institutions' financial assets in the rest of the EU and in the US increased (Chart I.15A), while the weight of the private sector continued to rise (Chart I.15B).

1.3 Liquidity risk

MARKETS

The volume of bonds traded in the Spanish *public debt* market up to June contracted by 25% in year-on-year terms. This contraction was uneven in that, while the level of activity in the over the *counter* wholesale market remained basically unchanged, the volumes of debt traded in the various electronic markets were down considerably compared with other years. Thus the weight of liquidity in the Spanish public debt market shifted from electronic trading to decentralised trading. The electronic markets went from a 49% share of held-to-maturity activity in the year ended June 2004 to around 30% in the same period of 2005.

On the *stock exchanges,* liquidity conditions, measured in terms of the share price range of the Spanish companies with the highest capitalisation, remained steady. In terms of activity, the upward path of share prices encouraged higher levels of stock exchange trading and there was growth of nearly 20% in the turnover of outstanding shares.

This favourable trend in stock exchange liquidity conditions is not incompatible with the generally highly uneven liquidity among listed shares. In relation to this matter, in June 2005 BME started to reform the stock exchange indices offered by it so as to facilitate the monitoring of shares of varying liquidity levels. The reform involved the scrapping the IBEX complementary and IBEX sectoral indices and the introduction of the so-called IBEX medium cap and IBEX small cap. As their names indicate, these indices relate to medium-capitalisation and small-capitalisation shares, respectively.

To be eligible to form part of these indices, shares may not form part of the IBEX 35, the percentage of floating capital[13] must be 15% or more and the ratio of annualised turnover to actual floating capital must be 15% or more. These requirements are based on the correlation established in practice between capitalisation and liquidity. These new indices introduced by the Spanish market mean that it can now track the market performance of shares belonging to three different liquidity groups. The 35 most liquid shares are those comprising the IBEX 35, the 20 next most liquid are included in the IBEX medium cap and another 30 make up the IBEX small cap. As a result of this definition in terms of ranking, revising the composition of a higher-liquidity subindex will affect the composition of lower-liquidity subindices.

INSTITUTIONS

On data to May 2005, the *net debit balance with the resident private sector,* both in business in Spain and in total business, increased with respect to December 2004. The strong credit growth, not matched by that of customer deposits, gave rise to a fresh addition to this net balance (Chart I.16A). This increase was seen in both commercial banks and savings banks (Chart I.16B). However, the (net) financing received by Spanish deposit institutions from non-resident sectors decreased, while the contribution from own funds steadied. Hence the increase in net financing to the resident private sector gave rise to a decline in the debit balance with general government and with banks.

The last FSR noted that the course of the net balance of commercial and savings banks as a whole with the resident private sector was largely determined by the behaviour of the debit balance with households. Both groups of institutions have net debit balances in operations with households (savings banks for the first time in May this year) and with the rest of the resident private sector, although the amounts are notably higher in commercial banks (Chart I.17A and C). However, at trend level, the differences are much smaller because the balance with the household sector has increased substantially since mid-2002 in both groups of insti-

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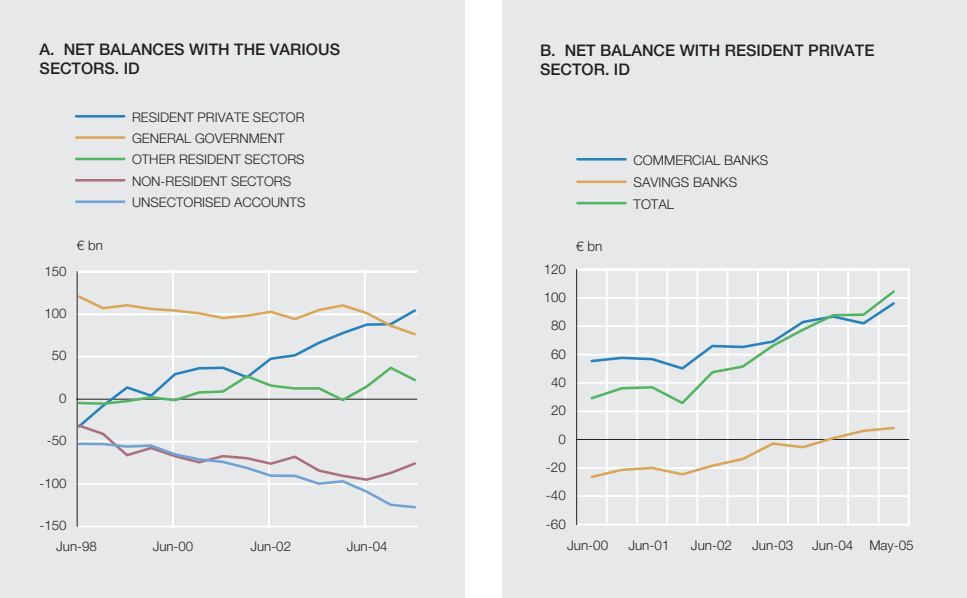
13. The floating capital of shares is the equivalent value of all those effectively available for circulation in the market. It is calculated on the basis of the shares admitted to trading and the adjustment thereto determined by the level of direct control holdings.

NET BALANCES WITH THE VARIOUS SECTORS. BUSINESS IN SPAIN CHART I.16

Commercial banks and savings banks. ID



SOURCE: Banco de España.

tutions, resulting in a change of trend compared with the previous stability. The behaviour of the debit balance with firms is also similar in the two groups of institutions, with a decline initiated at 2002 year-end and becoming increasingly marked.

These developments are largely due, in both commercial and savings banks, to the loss of relative weight in resident bank financing from *household* deposits (Chart I.17B and D). In any event, the distinct specialisation of commercial and savings banks in households and firms still remains substantially in place, both on the assets side and on the liabilities side. Thus in savings banks more than half of the financing received from the resident private sector comes from households, whereas in commercial banks it is only one-third. Commercial banks are in turn less specialised in financing to households than savings banks (less than 40% of credit to the resident private sector in the former, against more than half in the latter).

The development of new banking products and the entry of new agents (hedge funds) require the institutions to pay attention to counterparty risk. However, the exposure of Spanish institutions is very low in both business segments.

COMPARISON WITH EUROPEAN BANKS

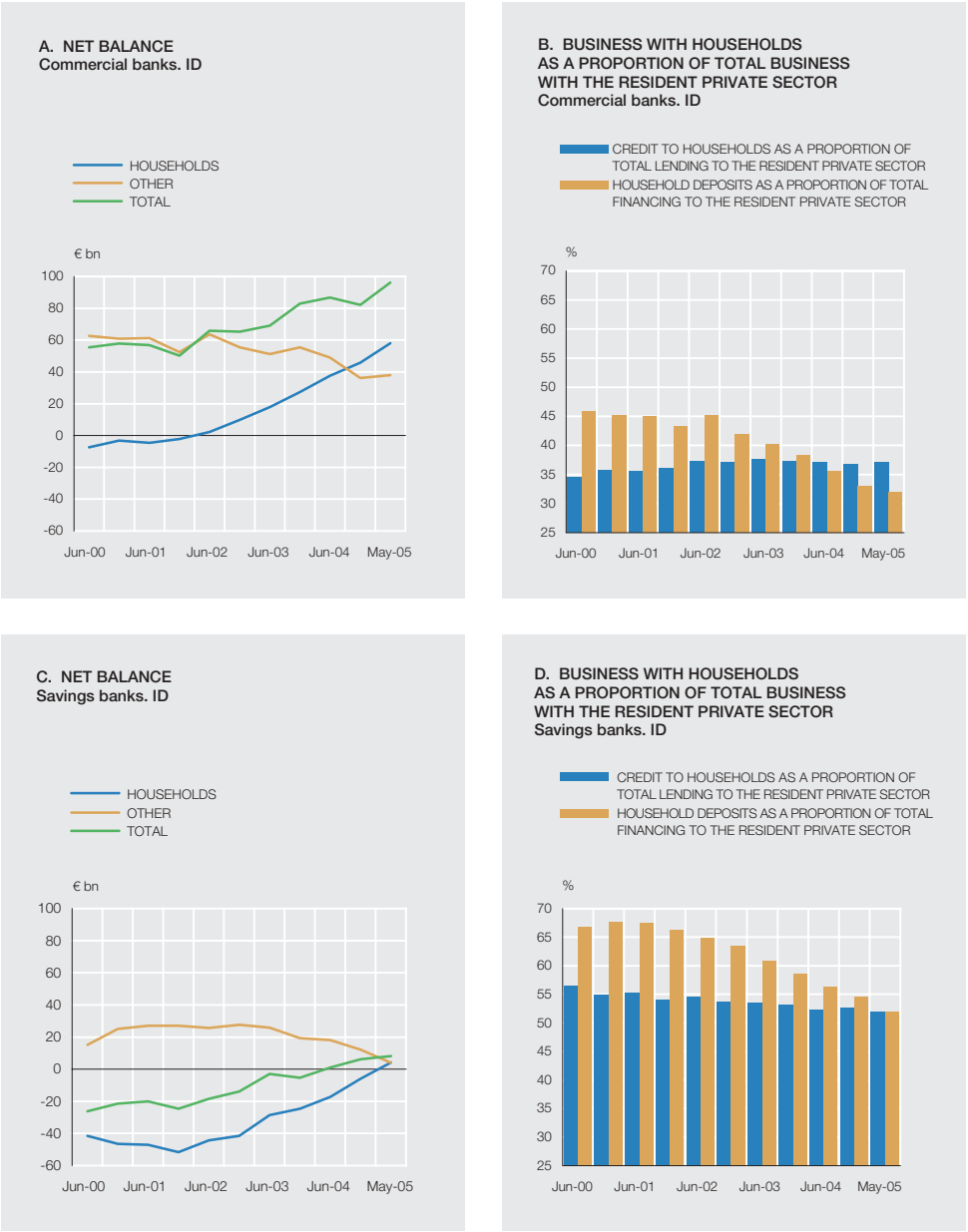
The ability of institutions to face a possible liquidity problem depends, among other things, on how easily they can obtain funds by selling their portfolio assets. This ability will depend largely on the counterparty and on the maturity of the assets concerned. Thus different liquidity ratios can be defined to take into account these factors, for example, cash on hand and short-term loans to the public sector plus credit to financial institutions and public debt securities as a ratio of total assets, or credit to the private sector as a ratio of deposits from the private sector.

Comparison of these two ratios with the average of those obtained for EU and euro area credit institutions as a whole[14] shows a somewhat less liquid position for Spanish institutions

14. See the report of the Banking Supervision Committee of the European System of Central Banks entitled "EU Banking Sector Stability", October 2005. This report is also used in Chapters II and III to compare the profitability, efficiency and solvency of Spanish and European credit institutions.

NET BALANCE WITH THE RESIDENT PRIVATE SECTOR. BUSINESS IN SPAIN CHART I.17

Commercial banks and savings banks. ID



SOURCE: Banco de España.

using the first ratio (between 5% and 15% lower than the EU and euro area averages, respectively) and, nevertheless, despite that fact that the financing to resident firms and households continues to exceed the funds received from these sectors, comparison of the second liquidity ratio defined above with the European average reveals that the position of Spanish institutions is very close to the average values of their European equivalents.

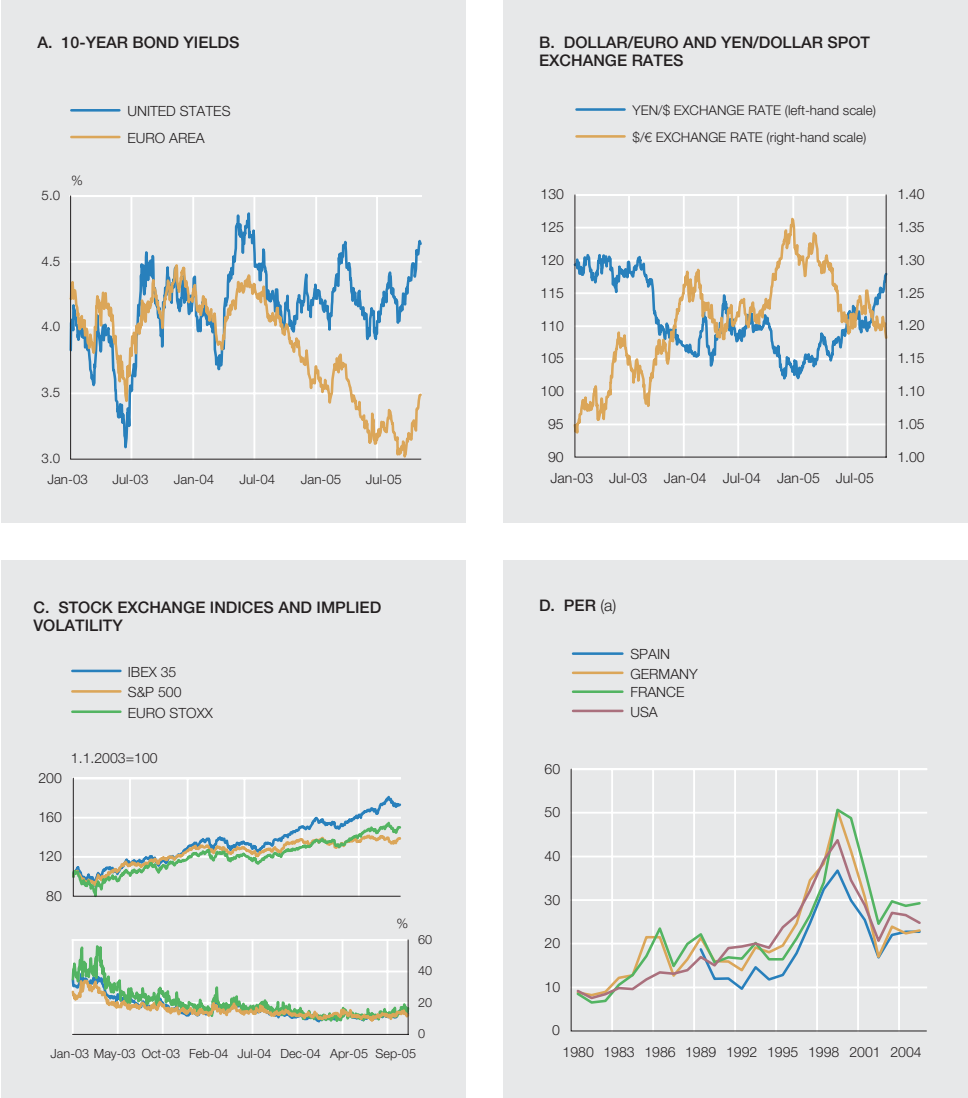
1.4 Market risk

MARKETS

The international financial markets performed favourably in 2005, in line with the good global macroeconomic behaviour. On occasions they even showed a high capacity to absorb potential pressure-inducing shocks, such as during the crises of certain automobile sector firms in the US in May, or the July terrorist attacks in London.

The US Federal Reserve continued to gradually tighten monetary conditions and at the beginning of November the official *interest rates* stood at 4%. The markets are discounting addi-

YIELDS, EXCHANGE RATES, SHARE PRICES AND IMPLIED VOLATILITY CHART I.18



SOURCES: Bloomberg, Datastream, Mongan Stanley and Banco de España.

a. The PER is calculated as the moving average of profit for the last 10 years, expressed in constant monetary units. The latest figure corresponds to August 2005.

tional increases that would take the official interest rate to 4.25% at year-end and further rises of 25 bp in 2006 to a level of 4.5% in 2006 Q1. Long-term US interest rates, although showing significant movements, held at low levels, within a range of 4% to 4.5% (Chart I.18A). Corporate bonds moved to correct partially the rise in the spread in May.

In the euro area money markets, the shorter-term interest rates held steady in the first half of the year. By contrast, one-year Euribor fell significantly in Q2, giving rise to a horizontal yield curve between the one and twelve month terms. These movements were partially corrected in Q3.

In the secondary public debt markets of the euro area, ten-year yields again fell in the first half of 2005, as compared with the wide upward and downward fluctuations around the 2004 year-end values in the US. As a result of these movements, the spread between US and German debt widened to nearly one percentage point. This behaviour subsequently continued and at the end of September long-term interest rates in the euro area stood at 3.1%, against 4.3% in the United States, which are historically very low levels.

On the foreign exchange markets the dollar fluctuated in 2005 around a general appreciating trend against the euro and the yen (Chart I.18B), partly underpinned by the gradual ongoing tightening of interest rates in the US. The more rigorous monetary policy was also reflected in a decrease in the slope of the yield curve in the US, where particularly low levels were reached. In the year as a whole, the dollar appreciated by 13% against the euro and by 12% against the yen, although it should be kept in mind that against the euro it started from a historical low (US$ 1.35 per euro).

The *equity* markets performed favourably in general, particularly in certain emerging economies and in Japan. Prices on the euro area stock markets have risen in 2005 to date, although with temporary set-backs in April and July related to the oil price hikes and the London terrorist attacks, respectively (Chart I.18C). This stock market performance was set against a background of low price volatility, a favourable corporate earnings outlook and low long-term interest rates.

Spanish indices rose by much the same as European indices. At the end of September[15], the Madrid Stock Exchange General index and the euro area broad Euro Stoxx index were up by 20% and 17%, respectively, since the beginning of the year, in contrast to the US S&P 500 index, which at the same date stood around its 2004 year-end levels. The across-the-board price rises on Spanish stock exchanges included most notably those in basic materials, industry and construction (46.8%) and oil and energy (30%). The greater unevenness across sectors in the European markets meant that, while energy and financial services rose by more than 35%, telecommunications slid back by around 5%.

Stock exchange prices and corporate earnings gave rise to scant movements in the PER (price earnings ratio) in Spanish and European markets and to a slight decline in the US (Chart I.18D). However, these indicators currently stand above their historical averages. In any event, the low risk premiums in numerous markets should not be overlooked.

The performance of the *Latin American stock exchanges* in the period was highly favourable, with record highs and yields that bettered those of stock exchanges in industrial countries (average rise in US dollars of around 25% at the end of October). Most exchange rates in the region appreciated against the dollar (up more than 7% in the area as a whole in Q3). This appreciation was particularly notable in the Brazilian real, which rose to its highest value for the last five years. The strength of the dollar against the euro in 2005 meant that the appreciation of the Latin American currencies against the euro was even greater (Chart I.19A and B).

Total *issuance* on the international markets in the first half of 2005 was nearly USD 24 billion, up one-third on the same period of 2004. However, since issuance grew more rapidly in other emerging areas, the weight of Latin American issues in total emerging markets declined further and now stands below 30%. This lower growth is mainly due to the low buoyancy of international sovereign issues as securities offerings directed at local markets rise in volume. In contrast, private sector issues rose strongly in the first half of the year, with Mexican corporate bonds playing a leading role.

As regards external financing, *net capital flows* to Latin America recovered somewhat in 2005. Notable among the components was the good behaviour of direct investment and, marginally, of portfolio investment. By contrast, the decline in commercial bank loans steepened. In addi-

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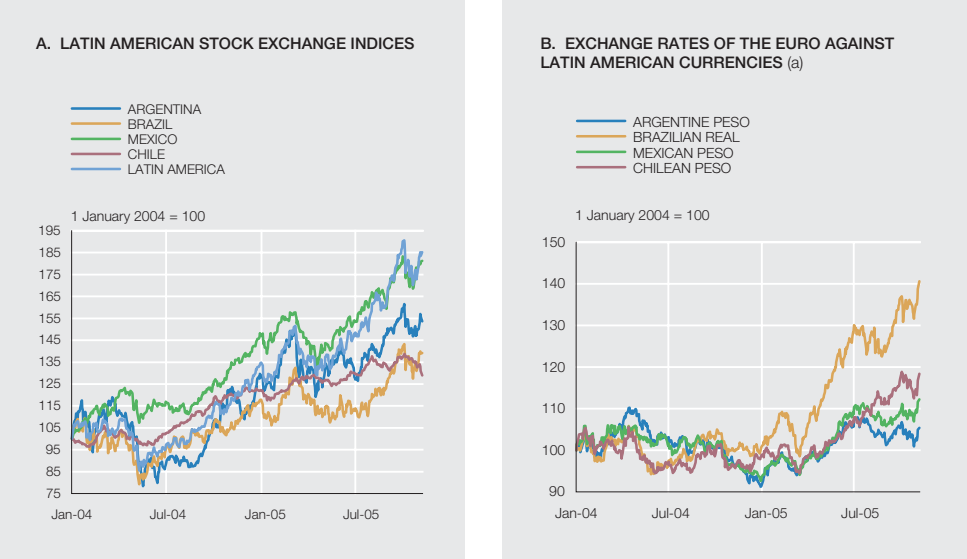
15. Information up to 26 September.

STOCK EXCHANGE INDICES AND EXCHANGE RATES CHART I.19



SOURCES: Datastream and Bloomberg.

a. Exchange rates: a fall indicates a depreciation of the local currency against the euro.

tion, official flows became more negative as net indebtedness to multilateral institutions decreased.

INSTITUTIONS

The information on market risk that can be found in the management reports published by credit institutions is very heterogeneous and, in some cases, excessively general. Most of the information available relates to the market risk associated with the *trading book,* defined as the risk associated with interest rates, exchange rates and financial asset prices.

Most of the large institutions have developed internal models designed, among other uses, to quantify the value at risk (VaR) of their trading book and conduct stress tests. The VaR estimates included by institutions in their management reports enable some simple inferences to be made at a more aggregate level. The methods used to calculate the VaR of trading books differ among institutions, as does the level of detail of the information and the data published. However, subject to the usual caveats applying in exercises of this type, some general conclusions can be drawn from the behaviour of VaR in institutions' portfolios.

According to the data in the reports of the larger Spanish deposit institutions, the VaR of trading books (estimated with a 99% confidence level and a one-day time horizon) represented very low percentages of their Tier 1 capital. After the decrease in 2003, the market risk associated with trading books rose in 2004, although the average VaR did not exceed 0.2% of Tier 1 capital and, in certain cases, this percentage was significantly lower. These percentages are in the lower range of those at larger institutions in other European countries and in the United States, which at times can exceed 3%.

In the first half of 2005, the market risk (measured by VaR) of larger Spanish institutions decreased by more than 30%, whereas there was no clear trend in other European institutions. This resulted in a decline in the importance of this risk with respect to the Tier 1 capital of institutions. Although the portfolios of larger Spanish institutions have fairly varied VaR levels, the dispersion, measured in terms of Tier 1 capital, did not exceed 0.1% at the end of the first half.

There is no exact formal definition of hedge fund (HF)[1]. In general, the term is understood to refer to a fund whose aim is to achieve high absolute yields not linked to average market yields, through strategies involving the management of high-risk assets and the exploitation of possible market inefficiencies. These strategies usually entail high levels of gearing and open positions in fixed-income securities, shares and derivatives that on occasions are not traded on organised markets. For this reason, HF shares are not generally very liquid. The activity of these funds is not, in general, subject to restrictions, since the regulations governing them are scant. Many of the HFs now in existence are domiciled in off-shore centres and carry on their operations in the United States and Europe, free from the specific regulations on other types of mutual funds and from their reporting and transparency requirements.

The recent growth of HF activity, their high gearing and the concentration in strategies of a certain type (crowded trades) in illiquid markets are factors that, in a stress scenario, could produce certain risks to financial stability. Accordingly, the monitoring and the possible regulation of these funds is a matter of debate in numerous international circles[2]. This concern is not recent. It first appeared in 1998 with the crisis of LTCM, a HF that put in difficulty a group of large internationally active commercial banks.

The exposure of EU banks to HFs varies across countries, but its relative importance does not seem to be very significant in relation either to total assets or to the size of the risks assumed by US banks. In Spain the information available on larger institutions seems to show that, in general, risks arise mainly from investment in HFs rather than from the financing granted to them and that, for the time being, these risks do not appear to have reached significant levels. According to some sources, the assets managed by these funds in Europe totalled nearly USD 230 billion at the beginning of 2005, as against USD 107 billion at the same date in 2004.

In Spain, the Collective Investment Undertakings Regulations enacted on 4 November 2005 (Royal Decree 1309/2005 implementing Law 35/2003 on Collective Investment Undertakings) govern the creation of Spanish HFs under the term collective investment undertakings authorised for unrestricted investment. These Regulations establish that the minimum investment in a HF is €50,000. Further, the marketing of these funds may not be addressed openly to all types of investors. Nevertheless, small investors can gain access to HFs through so-called funds of funds, which are provided for in the Regulations. These funds of funds have to invest at least 60% of their assets in HFs in Spain or other OECD countries, but may not concentrate more than 10% of their assets in any one fund. To foster investor protection, the Regulations impose on investors the obligation to sign a document in which they expressly state that they are aware of the risks involved in these products.

The main limitation in analysing the HF business is not only the paucity of data sources, but also their scope and reliability. In most cases the financial supervisors do not receive direct information from HFs and therefore only have available to them private databases[3] which gather information provided voluntarily by the funds and which often do not receive information when the funds incur a loss. Hence the aggregate data drawn from these databases is usually biased towards the more profitable funds.

Investors in HFs generally belong to high income and wealth strata since investment in these funds is generally subject to minimum levels and, furthermore, the marketing of their products is restricted. According to a study conducted in the United Kingdom by the Financial Services Authority (FSA)[4], the importance of funds of funds and of pension funds compared with private investors has been growing since 1996, accounting for 39% of total capital contributions in 2004.

At European level it does not seem for the time being that there is any intention to specifically regulate the activities of these funds, although there is a desire to promote greater transparency in financial reporting by them to the market, so that investors and lenders to these funds can appreciate the risk they assume.

The current discussion on the role of HFs in the financial system and their possible implications for financial stability basically revolves around the relationship between these funds and the banking system. Banks can assume both direct and indirect risk exposures to HFs. Direct risks derive from: i) the supply of financing to HFs, whether it be through repos, lines of credit to cater for unexpected liquidity shortfalls or other similar agreements (credit risk), ii) direct investment in HFs (market risk) and iii) trading with hedge funds in OTC markets (counterparty risk). Indirect risks arise mainly through the relationship with other financial institutions which in turn have a risk exposure to these funds.

The direct risks arising for banks that operate with HFs usually derive from their role as prime brokers of these funds. This relationship encompasses the provision of a wide range of services: lines of credit, cash management, securities lending, securities custody and administration, access to IT platforms, etc.

HFs are not limited to investing the resources received directly from investors. They can also resort to (normally secured) borrowing to increase the volume of their investments and achieve higher returns. A recent study by Fitch Ratings[5] estimates that HFs have around €8 billion of own funds, although, owing to their gearing, the assets in which they invest are a multiple of that amount. The funds that are most focused on taking short/long positions in equity securities tend to have less gearing than those that pursue strategies based on operating in fixed-income and credit derivatives. In the first case, the level of gearing is, according to certain sources, around twice the equity capital invested, while in the second case it seems to be in a range of around 10-20 times. The less highly reputed or less experi-

1. On the concept and regulation of hedge funds, see, for example, *Hedge Funds: Risks and Regulation* (2004) edited by T. Baums and A. Cahn. Institute for Law and Finance Series. **2.** See, for example, *Large EU Banks' Exposures to Hedge Funds,* ECB, 2005.

3. The main databases used include TASS, MAR, HFR, CISDM, Eurohedge, Van Hedge Fund Advisors and MSCI Hedge Funds Indices. **4.** See *Hedge funds: a discussion of risk and regulatory engagement.* FSA, 2005, Discussion paper 05/4. **5.** *Hedge funds: An Emerging Force in the Global Credit Markets,* Fitchratings, Special Report, July 18, 2005.

enced HFs borrow short term from banks whereas the more highly reputed ones, which usually have negotiating power with their lenders, tend to have more sophisticated financing arrangements which even allow them to raise funds in the capital markets.

In general, the financing granted to HFs is secured. However, sometimes this security consists of assets that are not traded on organised markets or that have low liquidity.

The relative importance of the degree of gearing of HFs and its implications are difficult to estimate. Not only can these funds borrow directly from banks, but also the investors in HFs (which include funds of funds) may have borrowed to invest in them.

The main implications for financial stability that can be drawn from HF activity come from the high relative level of gearing with which they operate and also from the role of these funds in risk transfer markets. Worth mentioning here is their growing role in credit markets and, more particularly, in credit risk transfer markets in which risk is transferred from banks to other investors. HFs control from 25% to 30% of the volume traded in the high-yield bond market and 80% of trading in distressed debt[6]. The activity in these markets means that HFs are financing borrowers with a high level of risk, in addition to contributing to finance the credit granted by traditional financial intermediaries.

The activity of HFs affects risk allocation in the system and helps to create markets for assets with a relatively high level of risk, thereby improving the financing opportunities of segments that would otherwise face severe credit restrictions. However, we cannot disregard the potential risks in the operations of these funds through chain reactions caused by the generally high gearing with which they operate. For this reason, the quality and rigour of the information furnished by these funds to investors and, in general, to the market take on particular importance. In the case of banks, this information becomes an essential requirement for the application and good working of the models and tools used as a guide in their risk management and, in short, for the implementation of good credit policies.

6. See on this subject: Bank of England (2004), *Financial Stability Review,* June and December.

In some of the larger European institutions, there was also a trend for VaR to decrease as a percentage of tier 1 capital.

The estimates of market risk that are based on the estimation of VaR must be regarded with caution, not only because of the differences between institutions in the methodology used and the types of risk considered, but also because these estimates do not allow conclusions to be drawn about the sensitivity of total banking activity to interest rate movements. For this reason, institutions conduct internal stress tests to enable them to consider alternative scenarios. It should be noted that these exercises depend to a certain extent on recently observed data and hence there is some uncertainty about how their results may differ in scenarios subject to significantly higher market volatility than in the one observed.

In addition to the trading book models, large institutions have developed internal models to monitor and quantify the market risk associated with their overall asset and liability management (structural interest risk). The main structural interest risk analysis tools used by most institutions are maturity gap (asset and liability interest rate repricing) and asset and liability duration. These tools enable institutions to simulate how hypothetical changes in interest rates affect the net interest margin and economic value.

Further, with regard to interest risk, it should be noted that interest rate fluctuations may affect credit risk through their possible effects on the probability of default by borrowers. Capturing and estimating these effects is very complex because they depend on the size of the change in rates and on the level of borrower debt.

As far as market risk is concerned, attention should be paid to the growing role of certain non-traditional financial intermediaries, such as hedge funds, in risk transfer markets as sellers of protection (Box I.4). The particular nature of these intermediaries' operations means that banks have a greater need for adequate information and for appropriate systems to control and manage their risk exposure to hedge funds.

II Profitability

II.1 General situation

In contrast to the weakness displayed by the euro area as a whole, the situation of the Spanish economy, in terms of GDP growth, remains favourable. Also, despite the slowdown in some countries, the main Latin American countries have performed favourably. These factors have helped to keep the profitability of Spanish institutions generally in line with the levels observed in previous issues of the FSR. The buoyancy of activity and the ongoing drive by institutions to contain their operating costs contributed to this outcome.

However, the comparisons made with the same period of the previous year must be treated with great caution since, as pointed out in Chapter I of this report, the June 2005 data were compiled in accordance with the new CBE 4/2004. A like-for-like comparison with the previous year would therefore require the accounting figures for 2004 to be re-calculated on the basis of the criteria introduced by that Circular. However, as at the date of preparation of the IEF this information is not fully available, so that the June 2004 data should be considered estimates and, therefore, subject to revision[1]. However, subject to these caveats of an exceptional nature, the data offered in this chapter do show the general trends in the profitability of Spanish deposit institutions.

The *group net income* of deposit institutions as a whole[2] grew at a similar rate to that indicated in the last issue of the FSR, confirming the solidity of income developments since negative rates of growth were recorded in 2002. However, the growth of total assets (TA)[3] was greater, so that in relative terms group net income fell slightly to 0.82% (Table II.1)[4]. For its part, ROE stood at 13.5%, which was once again above the yield on long-term Spanish public debt (Chart II.1A)[5].

Net interest income, which in absolute terms was (10.7%) higher than in the previous year, declined in relative terms to 1.70%[6]. This trend, already noted in the last FSR, is largely explained by the highly competitive environment in the sector, and by low levels of interest rates[7]. The differential between the yield on non-interbank loans and receivables and the cost of non-interbank financing received narrowed again in the six months to June 2005.

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1. That is to say, the comparison between 2005 and 2004 should be based on data compiled using the same accounting criteria. However, the information available when this issue of the IEF went to press only enables an approximation to be obtained of the 2004 data according to the new accounting criteria. Owing to the magnitude of the accounting changes, which has required the institutions and the Banco de España to carry out a significant amount of work over a short space of time, complete information for 2004 is still not available with the necessary quality guarantees. **2.** The branches of foreign banks based in other European Union countries are not included in either this or the following chapter of the FSR as they are not subject to capital requirements in Spain. The number of institutions analysed in both chapters is therefore the same. The relative weight of the excluded institutions is very small. **3.** Exceptionally, since only estimates are currently available for dates prior to June 2005, the items of the income statement are shown in this issue of the FSR relative to total assets and not average total assets. **4.** There are some differences between certain groups of headings of the analytical income statement included in this chapter and the public income statement. **5.** Valuation adjustments, which CBE 4/2004 considers equity, were included in the calculation of this ROE. When these adjustments are removed from the denominator, the ROE reaches 15.3%. As indicated in Chapter I, most of these valuation adjustments are attributable to the capital gains existing in the portfolio of assets available for sale. **6.** A further caveat should be mentioned in relation to the comparison with the data for the previous year. In the last FSR it was indicated that a large British institution was acquired by a Spanish one in December 2004. The data used in June 2005, unlike in the same period of the previous year, incorporate the effects of this acquisition, including the notable growth of total assets. **7.** The loss of welfare attributable to the non-existence of perfect competition in the credit market should be measured taking into account the risk premium, or else overestimates are obtained that distort the assessment of the degree of competition in credit markets. Box II.1 explains the conceptual framework for adequately measuring this loss.

CONFIDENTIAL INCOME STATEMENT TABLE II.1

Deposit institutions

	JUNE 05		JUNE 04
	€ m	% TA	% TA
Financial revenue	40,612	3.74	3.96
Financial costs	22,152	2.04	1.83
Net interest income	**18,460**	**1.70**	**2.13**
Share of profit or loss of entities accounted for using the equity method	1,931	0.18	0.27
Net commissions	8,272	0.76	0.91
Gains and losses on financial assets and liabilities	2,673	0.25	0.17
Gross income	**31,336**	**2.89**	**3.48**
Operating expenses	16,869	1.55	1.88
Other operating income	578	0.05	0.02
Net operating income	**15,045**	**1.39**	**1.62**
Asset impairment losses	2,353	0.22	.
Provisioning expense (net)	1,726	0.16	.
Other income (net)	1,511	0.14	0.10
Profit before tax	**12,263**	**1.13**	**1.23**
Net income	9,493	0.87	0.94
MEMORANDUM ITEM:			
Group net income	8,944	0.82	0.89

SOURCE: Banco de España.

Following the introduction of the new accounting rules, various aspects of the calculation of net interest income have been changed. As regards financial costs, they now include the payments that have to be made to the holders of preference shares if the institution makes a profit. This is because, for accounting purposes, these instruments are no longer considered capital, but financial liabilities, and therefore payments made to their holders are treated as a financial cost for the institution.

Financial revenue, for its part, is made up of interest and similar income and the dividends received from capital instruments (shares). With respect to the latter, under CBE 4/1991, the dividends from investments in group entities, subsequently set off against an item included in the profits from group transactions (below net operating income), could be recorded here. This is not possible with CBE 4/2004 since, in the consolidated statements, only the dividends from other capital instruments of investees other than associates, jointly controlled entities and group entities are considered in the calculation of financial revenue.

The calculation of interest and similar income has also been affected by the treatment in the new Circular of commissions. The commissions in question are those arising as consideration for the commitment to provide financing, for example, commitment fees. With CBE 4/1991, these commissions were fully recognised as financial revenue at the time the transaction was granted. CBE 4/2004 establishes that the recognition of the revenue from these commissions shall be deferred and recognised over the life of the loan, except for that portion of the commission which compensates for the costs the institution would not have incurred had it not agreed to the transaction. Unlike the two previous effects, which have been considered in the

CREDIT RISK AND THE CALCULATION OF WELFARE LOSS

BOX II.1

Equilibrium in perfectly competitive markets is efficient because there are no welfare losses. However, in practice, markets are rarely perfectly competitive. When equilibrium prices (quantities) are higher (lower) than those that would obtain if price were equal to marginal cost there is a loss of welfare that can be calculated, for example, using the Harberger triangle.

In the credit market, the interest rate which deposit institutions apply to their loans is determined by the intersection of the marginal income and marginal cost curves. The chart below depicts the demand for credit function (JD curve), marginal income (JI) and marginal cost curves determining different equilibria for the purposes of analysis[1]. On the reasonable assumption that the interbank rate (r_{ib}) drives a wedge between interest rate setting decisions in the loan and deposit markets, and considering that the marginal operating costs of credit and deposits are either almost fixed in the very short-term or impossible to calculate separately for each of the many products offered by a bank, this rate can be used by deposit institutions as a measure of their marginal cost. Assuming linear demand and cost functions (Chart A), equilibrium would be determined by the interest rate r_l and the amount lent L, the lost of welfare being equal to the area of the triangle abc. This loss of welfare is equal to that part of the consumer surplus in perfect competition (triangle $Jr_{ib}c$) which is not appropriated in the banking market either by consumers (whose surplus is Jr_la) or by deposit institutions (whose margin is equal to $r_lr_{ib}ba$).

The foregoing analysis is standard in banking literature. However, deposit institutions assume an additional cost in their lending activity arising from *credit risk.* Thus, the marginal cost of lending an additional unit of money should include the *risk premium* to cover the possibility that the institution will not recover either the principle or the agreed interest. As a result, the marginal cost of the loan is the sum of the interbank rate plus the risk premium on the loan considered (in the chart, r_{ib}+PR). Equilibrium in the credit market would be determined by the combination of the interest-rate r_l^{PR} and the volume of loans L*. Assuming linearity, the higher cost of financing results in a smaller consumer surplus, a lower margin for banks and a *smaller loss of welfare* than in a risk-free market (triangle a*b*c*).

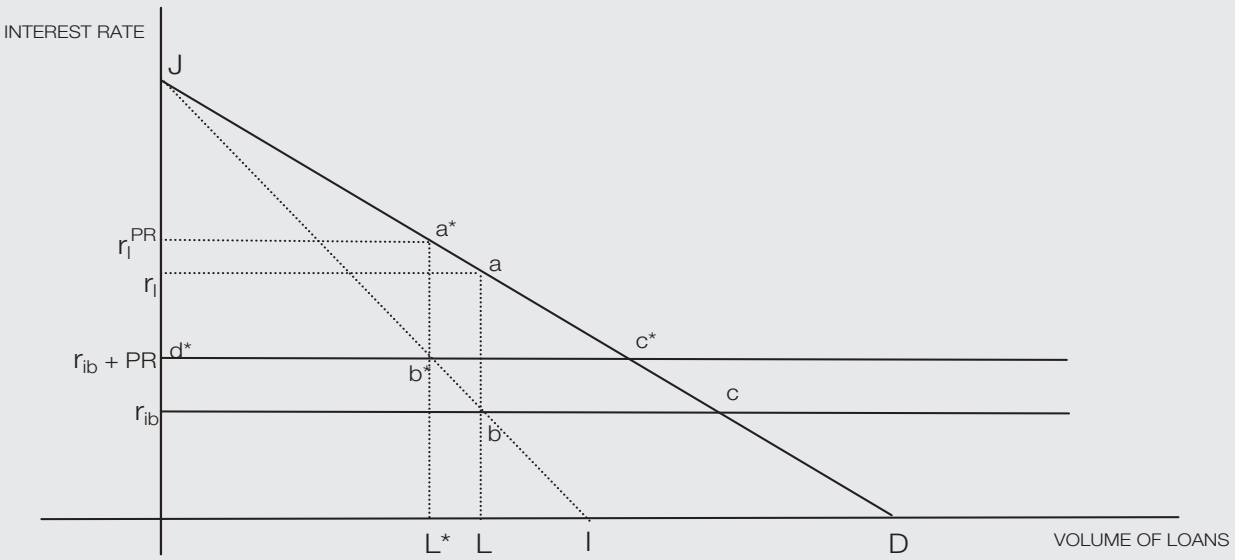
Accordingly, when evaluating the social cost of the lending activity of deposit institutions, it is essential to take into account the cost of the expected loss due to credit risk. Otherwise, the welfare loss arising from the departure from a situation of perfect competition is overestimated. The amount of the overestimate varies from product to product and may be very large[2].

1. In order to simplify the exposition, the curves have been assumed to be linear; the main results are not modified by a change in this assumption.

2. The unpublished paper by A. Martín, V. Salas and J. Saurina entitled "Risk premium and market power in credit markets" shows that the amount of the overestimate in the case of some products and time periods is more than double the welfare loss calculated when the credit-risk effect is corrected for.

LOSS OF WELFARE IN THE LOAN MARKET

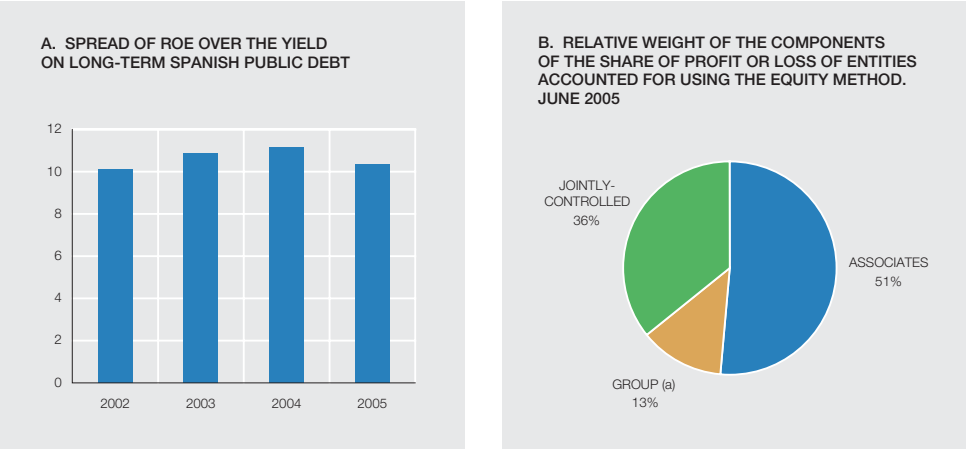
CHART A



ROE AND SHARE OF PROFIT OR LOSS OF ENTITIES ACCOUNTED FOR USING THE EQUITY METHOD

CHART II.1

Deposit institutions



SOURCE: Banco de España.

a. Includes subsidiaries accounted for using the equity method (inter alia, insurance and non-financial corporations).

estimation of the 2004 data, it has not been possible in this latter case to control these effects owing to lack of information for dates prior to June 2005.

Also, the application of the new accounting Circular means that the *share of profit or loss of entities accounted for using the equity method* is now recorded as ordinary income. This item records the profit or loss attributable to the group generated during the period by associates, and by jointly controlled entities when the equity method has been chosen for their measurement[8]. Their equivalent, under CBE 4/1991, was included in profits from group transactions, beneath net operating income.

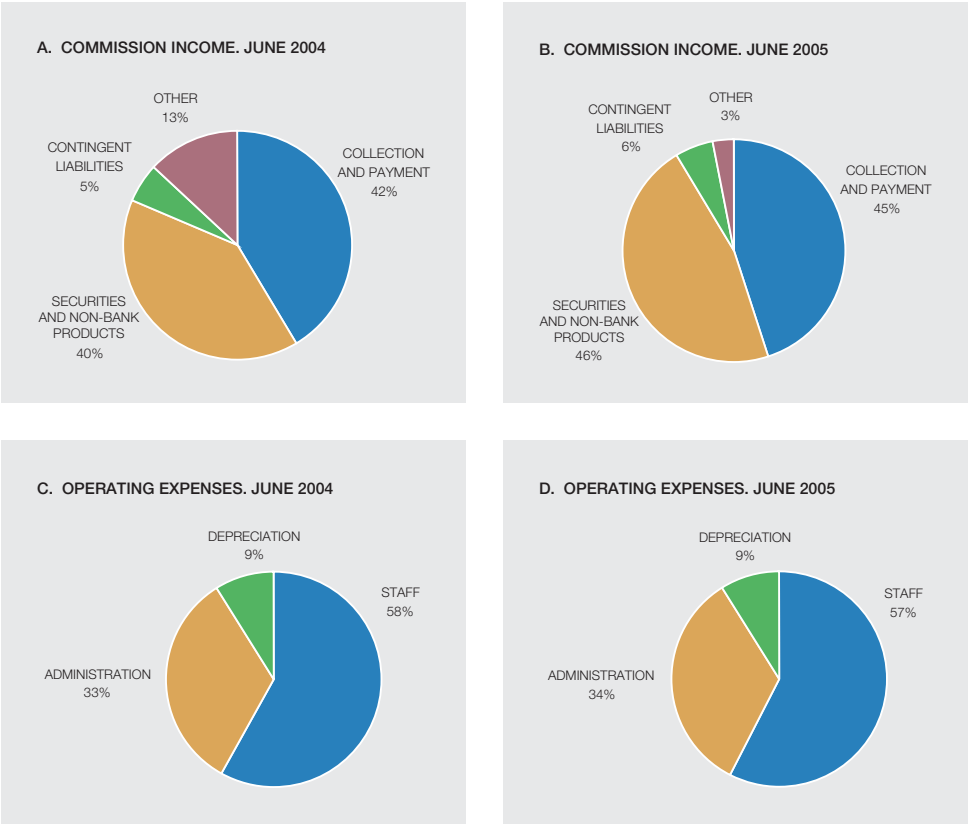
The relative weight of this item in total assets is 0.18%, down 9 bp from the estimate for June 2004. However, the June 2004 data may be overestimated if, as mentioned in Chapter I, some institutions have classified part of their associates as available-for-sale financial assets. Within this item, profits generated by associates have the highest relative weight (Chart II.1B).

Commission income, which in absolute terms maintained the growth observed in the last issue of the FSR, fell in relative terms to 0.76% of total assets. The contributions of the various types of commission to total revenues did not change significantly between June 2004 and June 2005, although there were some differences (Chart II.2A and B). In June 2005, the relative weight of commissions for collection and payment services and of those relating to securities services and the sale of non-bank products was higher. The former rose from 42% of commission income in June 2004 to 45%. The relative importance of commissions relating to securities and the sale of non-bank products increased more sharply, rising from 40% to 46% in June 2005. Those relating to securities largely depend on stock market developments, which have been favourable this year, while those arising from the sale of non-bank products have been notably buoyant in recent years, in line with the recovery in the net assets of mu-

8. Box II.2 analyses the sectoral distribution of the investments of commercial banks and savings banks in non-financial corporations.

RELATIVE WEIGHT OF COMMISSION INCOME AND OPERATING EXPENSES CHART II.2

Deposit institutions



SOURCE: Banco de España.

tual funds and, to a lesser extent, with the stepping up of banks' sales of insurance products.

Gains and losses on financial assets and liabilities increased in relative terms by 8 bp to 0.25% of total assets. This growth stems partly from the favourable stock market developments mentioned above, but it should also be taken into account that the estimation of this item in 2004 is complicated. For example, there were changes to the financial instruments that make up the held-for-trading portfolio; under the new Circular any financial asset can be included, subject to a number of conditions (e.g. trading derivatives, loans and advances to other debtors and deposits from credit institutions), while under CBE 4/1991 only fixed-income securities and equities were included.

Nevertheless, *gross income* grew by 15%, although in terms of total assets it declined from June 2004, to 2.89%. However, the factors mentioned above, which may mean that the June 2004 figure is overestimated, should be taken into account, for example, in the calculation of the share of profit or loss of entities accounted for using the equity method.

Operating expenses fell by 33 bp to 1.55%. There was nothing new in this since, as was apparent in the last issue of the FSR, Spanish deposit institutions are making significant efforts to rationalise their operating costs, which is certainly fundamental to operating with a guarantee of success in a market as competitive as the banking one. The efficiency ratio of deposit institutions as a whole fell by 10 bp to 53.8%. The structure of operating expenses was practically unchanged in June 2005 from the same period of the previous year (Chart II.2C and D).

THE HOLDINGS OF DEPOSIT INSTITUTIONS IN NON-FINANCIAL CORPORATIONS

BOX II.2

This box analyses the equity investments of deposit institutions in non-financial corporations. Deposit institutions have holdings in a large number of corporations. However, the analysis here focuses on holdings of more than 0.1% of the own funds of the entity, thereby eliminating a large number of holdings that, overall, have a very low weight (less than 10% of the book, or accounting, value of the portfolio of industrial holdings). That said, all holdings have been taken into account, whether classified in the trading book, available-for-sale or permanent holdings portfolio. The book value of the industrial holdings of deposit institutions amounted, as at December 2004, to €38,964 million, 48.6% of which belonged to commercial banks, 50.6% to savings banks and the remaining 0.8% to credit co-operatives.

Deposit institutions held 89.3% of the book value of these investments (€34.8 billion) in Spanish non-financial corporations and the remaining 10.7% in foreign ones. Savings banks held a slightly higher percentage in Spanish corporations (93%) than commercial banks (85.4%). The book value of listed corporations represents 72.5% of the total, this percentage being higher in the case of commercial banks (76.6%) than in that of savings banks (69.3%).

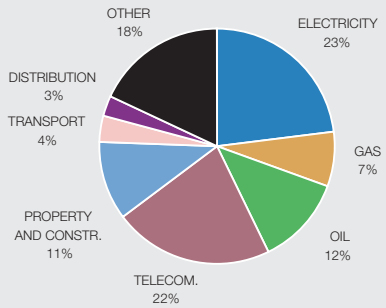
The permanent holdings portfolio, that is to say the industrial holdings in subsidiaries, associates and jointly controlled entities, represents 57.5% of the book value of all the industrial holdings of deposit institutions. This percentage is 38.9% in the case of commercial banks, with the rest corresponding to the available-for-sale portfolio and the trading book. For their part, savings banks held 75.5% of their holdings in the permanent holdings portfolio and the rest in the available-for-sale portfolio, their trading book being practically non-existent.

The difference between the fair or listed value and the book or accounting value of the holdings in non-financial corporations shows the unrealised capital gains of the deposit institutions. These capital gains must be in the permanent holdings portfolio or in the available-for-sale portfolio since, for accounting purposes, the trading book is

COMPOSITION OF HOLDINGS IN NON-FINANCIAL CORPORATIONS BY BRANCH OF ACTIVITY. BOOK VALUE. DECEMBER 2004

CHART A

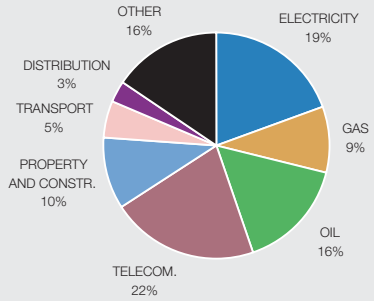
Deposit institutions



COMPOSITION OF HOLDINGS IN NON-FINANCIAL CORPORATIONS BY BRANCH OF ACTIVITY. FAIR VALUE. DECEMBER 2004

CHART B

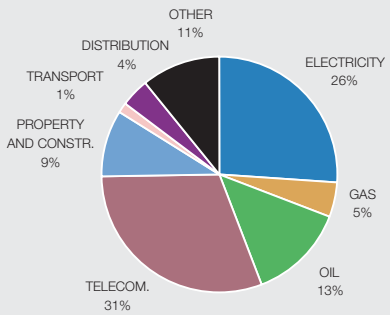
Deposit institutions



COMPOSITION OF HOLDINGS IN NON-FINANCIAL CORPORATIONS BY BRANCH OF ACTIVITY. BOOK VALUE. DECEMBER 2004

CHART C

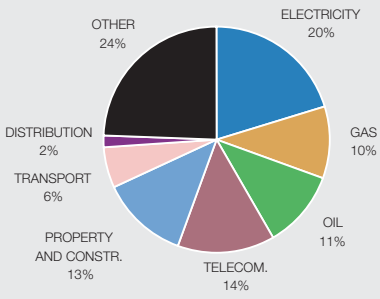
Commercial banks



COMPOSITION OF HOLDINGS IN NON-FINANCIAL CORPORATIONS BY BRANCH OF ACTIVITY. BOOK VALUE. DECEMBER 2004

CHART D

Savings banks



SOURCE: Banco de España.

measured at fair value. Permanent holdings are measured for accounting purposes by the portion of the net worth of the investee that they represent, so that the unrealised capital gains represent the extent to which the market has positive future expectations for the value of the firm in question, i.e. by how much more than its underlying book value it values the holding. The available-for-sale portfolio is measured for accounting purposes at the lower of the acquisition cost and the market price (if listed) or the book value (if not listed), so that the capital gains show the difference between the market price and the cost at the time of acquisition.

The unrealised capital gains on the industrial holdings of deposit institutions amounted, as at December 2004, to €18,581 million, that is to say 47.7% of their book value. This appreciation in their value basically arose: 1) among the listed corporations, the fair value of which was 63.7% higher than their book value, while for unlisted corporations it was only 5.5% higher, and 2) in the permanent holdings portfolio, where the fair value is 75.5% higher than the book value.

The unrealised capital gains on the industrial holdings of commercial banks represent 31.1% of their book value (39% in the case of listed corporations and 5% in that of unlisted ones). For savings banks, the total capital gains are 64.4% of the book value of their holdings (90.2% in the case of listed corporations and 6% in that of unlisted ones).

The main branches of activity in which deposit institutions invest is energy, which represents 42% of the book value of their holdings (23% electricity, 7% gas and 12% oil), followed by telecommunications which represents 22%, and construction and property development 11%. Finally, 9% was invested in transport, distribution and hotels and 17% in other branches of activity (Chart A). These percentages are similar when the market value of the portfolio is used (Chart B).

The percentage of the holdings of the commercial banks in energy is similar to that of all deposit institutions, but they have a higher proportion of such holdings in electricity and a lower proportion in gas. The other significant difference between the commercial banks and deposit institutions as a whole is their telecommunications investments, those of the former representing almost a third of their total investments. Savings banks have a more diversified portfolio than banks and, compared to all deposit institutions, have a lower proportion of their holdings in telecommunications and a higher proportion in property and transport and in other activities (Charts C and D).

Finally, it should be noted that the new accounting Circular could result in changes in the institutions' policies with respect to their company holdings. At the time this issue of the FSR went to press there was not sufficient information available for these changes to be quantified in detail, but this will be a factor to consider in future reports.

Other operating income, the equivalent of which in CBE 4/1991 was included beneath net operating income, has a low relative weight in terms of total assets (0.05%). It was slightly higher than in June 2004, although this was partly attributable to the fact that other operating income includes that portion of commissions, for the commitment to grant financing, which compensates for the costs that the entity would not have incurred had it not agreed to the transaction.

The above effects explain why *net operating income* grew (18.3%), even though it fell in terms of total assets, to 1.39%. Between net operating income and the net income for the period the income statement has changed significantly, following the introduction of CBE 4/2004, so that no direct comparisons can be made between the new items and those defined under CBE 4/1991.

Asset impairment losses, which represent 0.22% of total assets, reflect the impairment allowances made, net of recoveries, when there is objective evidence of impairment. If the observable data are insufficient, or do not adequately reflect the current circumstances, experienced judgement shall prudently be used to estimate these losses. Impairment losses are classified into five groups: those arising from available-for-sale financial assets, from loans and receivables, from the held-to-maturity portfolio, from that of investments and other losses. In June 2005, 98.7% of the impairment losses were attributable to loans and receivables, i.e. to the typical lending activity performed by institutions.

Under CBE 4/1991, impairment losses on loans and receivables were provisioned by means of specific, general and statistical bad-debt provisions. With the new Circular, the comparison with the bad-debt and country-risk provisions existing under CBE 4/1991 is complicated. The

estimates made show a decrease, in terms of total assets, from 0.37% in June 2004 to 0.23% in June 2005. However, this reduction cannot be attributed entirely to the behaviour of doubtful assets, but must partly stem from the application for the first time of the new system for calculating allowances and provisions introduced by CBE 4/2004, which it has not been possible to consider in the estimation of the June 2004 data[9].

Meanwhile, *provisioning expense,* which amounted to 0.16% of total assets, includes the provisions made for pensions and similar obligations, for taxes, for contingent exposures and commitments and others. The latter have a relative weight, in this item, of 80%, followed by those made for pensions (14.9%).

Other income includes the net gains (losses) obtained (incurred) in the ordinary activities of the institution. Although the comparison with the June 2004 data is subject to the limitations mentioned above, this item rose 4 bp to a relative weight of 0.14%. This slight increase is due to the fall in losses, while gains held steady at around 0.19% of total assets.

II.2 Analysis based on individual institutions

The distribution of institutions according to their ROE remained relatively stable between June 2004 and June 2005 (Chart II.3A and B). In fact, although some large institutions moved towards lower ROE levels, as at both these dates around 75% of institutions came within the 5-15% range, which is above the yield on long-term Spanish public debt.

The distribution of institutions according to their efficiency ratio (Chart II.3C and D) also displays the stability mentioned when analysing deposit institutions as a whole. Distinguishing between commercial banks and savings banks, the former continued to show higher levels of efficiency than the latter (52.6% as against 55.1%, respectively, in June 2005).

COMPARISON WITH EUROPEAN BANKS

Activity in the euro area picked up slightly in 2004, with a GDP growth rate of 1.5% (0.9% in 2003). At the same time the developments on financial markets and, in particular, stock markets were very favourable, especially in the final quarter of 2004. Accordingly, European banks were operating in a more favourable environment than in previous years.

The data available for December 2004 show that, in comparison with the European average, Spanish institutions enjoy high levels of profitability (Chart II.4A). Net interest income is more than 35% higher than the average for the 25 EU countries, while that percentage reaches almost 50% when the comparison is with the euro area countries. The specialisation of Spanish institutions in retail banking is significant: credit to the private sector represents more than 60% of assets, while the European average is barely over 50%, and the deposits of this sector are more than 55% of its assets, as against the European average of 40%. This specialisation has become even stronger during 2004 and in 2005 to date, owing to the strong growth of credit in Spain and the acquisition of a British institution highly specialised in credit for house purchase. This, along with significant activity in Latin America, where margins are generally higher, and the fact that the appreciation of the euro against some of the main Latin American currencies came to a halt in 2004, helps explain the higher net interest income of Spanish institutions.

The net commissions of Spanish institutions are 15-25% higher than the European average. This is attributable, in particular, to developments in foreign operations, where net commissions grew both in absolute terms and as a percentage of assets. All of which goes to ex-

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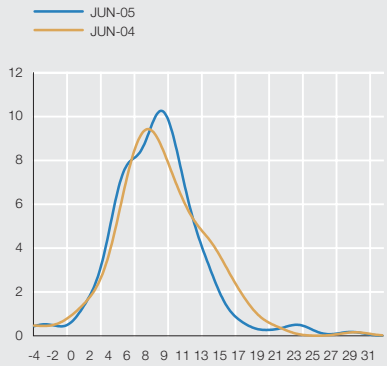
9. Box III.1 of the last issue of the FSR analysed in detail the new provisioning system, which contains a macroprudential element strengthening the solvency of Spanish deposit institutions.

DISTRIBUTION OF INSTITUTIONS ACCORDING TO THEIR ROE AND EFFICIENCY RATIO

CHART II.3

Deposit institutions

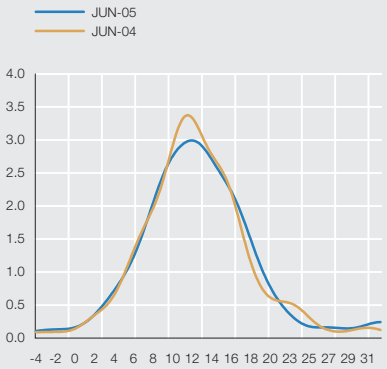
A. DISTRIBUTION OF INSTITUTIONS ACCORDING TO THEIR ROE



B. DISTRIBUTION OF INSTITUTIONS ACCORDING TO THEIR ROE

ROE BRACKETS	JUN-04 No. INST.	JUN-05 No. INST.
<0	8	6
0-5	19	25
5-10	80	84
10-15	48	46
15-20	15	5
>20	3	7

C. DISTRIBUTION OF INSTITUTIONS ACCORDING TO THEIR EFFICIENCY RATIO



D. DISTRIBUTION OF INSTITUTIONS ACCORDING TO THEIR EFFICIENCY RATIO

EFFICIENCY BRACKETS	JUN-04 No. INST.	JUN-05 No. INST.
>100	8	9
90-100	2	2
80-90	10	7
70-80	23	30
60-70	51	49
50-60	50	48
40-50	21	19
< 40	8	9

SOURCE: Banco de España.

plain why gross income is more than 20% higher in Spanish institutions than in European ones.

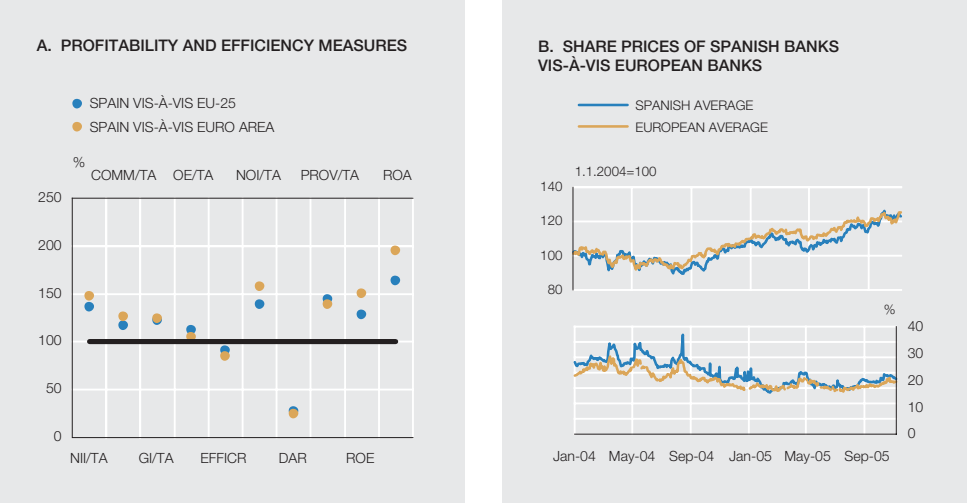
The constant drive by Spanish institutions in recent years to contain costs with reductions or very moderate increases in operating expenses meant that the latter were barely more than 10% above the European average, resulting in a favourable position for Spanish institutions in terms of efficiency, with a 10-15% lower efficiency ratio.

As a result of all the foregoing, the net operating income of Spanish institutions was more than 60% higher than the euro area average and almost 40% higher than the EU average.

Finally, the comparison in terms of the doubtful assets ratio is also favourable to Spanish institutions, although the comparison should be made with caution since the definition of doubtful assets varies from country to country. This is also true for bad-debt allowances, although in this case those of Spanish institutions, which include the statistical provision, are higher.

COMPARISON WITH EUROPEAN BANKS CHART II.4

Credit institutions



SOURCES: BSC, DataStream and Banco de España.

Higher margins, greater efficiency, lower doubtful assets ratios, despite the larger bad-debt allowances, of a prudential nature, mean that both the ROE and the ROA of Spanish institutions are still, on average, much higher. This comparison is especially favourable when it is made with the other euro area countries.

The *stock market information* on large Spanish banks shows very similar behaviour to that of other large listed European banks. The share prices of both the Spanish and other European banks regained their levels of the first half of 2002. Since January 2005 the prices of both groups of institution have risen by 10%; in the first few months of 2005 European banks performed better, while the situation has been the reverse since May (Chart II.4B).

Implied volatilities, for both Spanish and European banks, have remained relatively stable since the last issue of the FSR.

The risk premiums on the *credit default swaps* (CDSs) of European banks edged up at the beginning of May, although they are again at the lowest levels of recent years. The senior and subordinated debt premiums of Spanish institutions are below the average for European institutions.

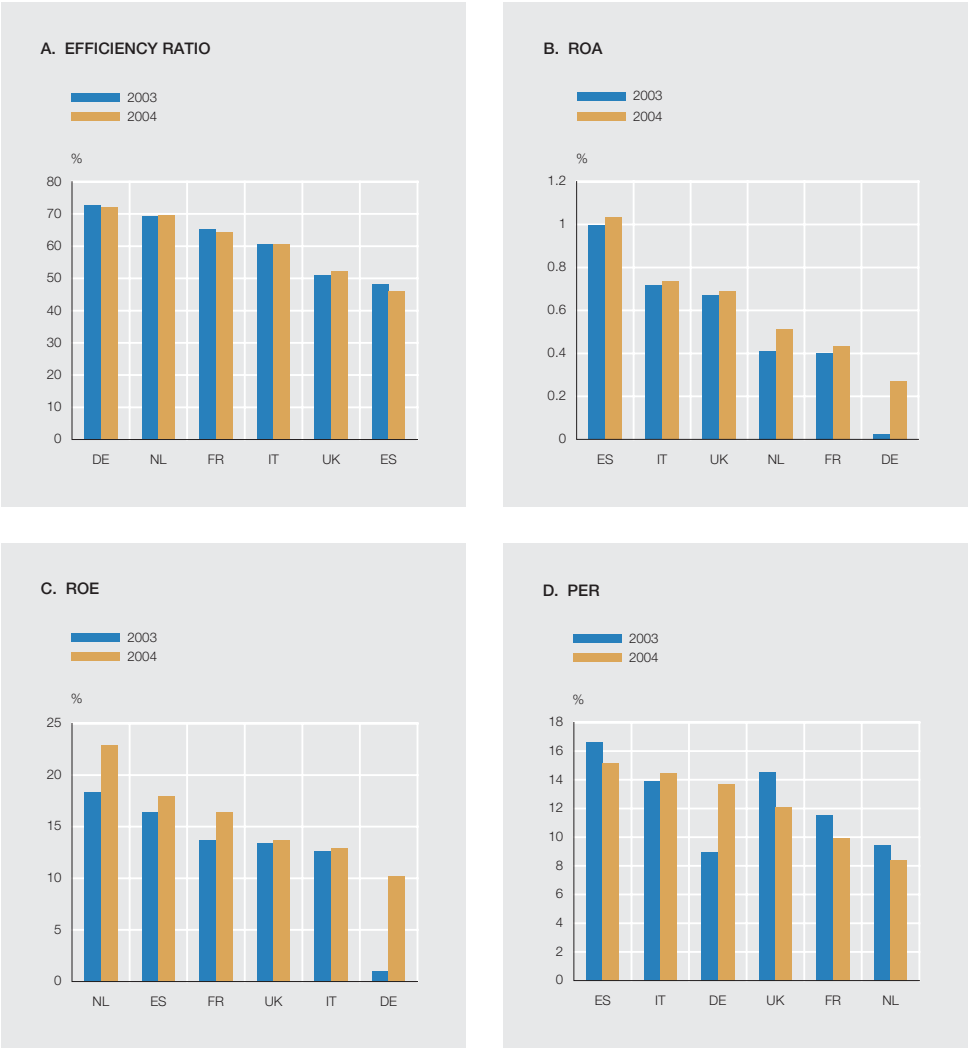
The *betas* of large Spanish banks have not changed significantly since the last issue of the FSR, stabilising at close to one. Compared with the large European banks, Spanish ones are still in the intermediate-high range.

Comparison of the large *European banks*[10], based on 2004 data, shows the high level of efficiency of Spanish and British institutions (Chart II.5A), which helps explain their position in terms of the returns on assets and on equity (Chart II.5B and C). The profitability of large European banks rose in 2004, particularly of those banks with the lowest levels of profitability in 2003. Part of this increase is attributable to greater efficiency, but not in all cases.

10. The sample of large European banks is composed of three German institutions, three French, three Italian, two Dutch, four British and two Spanish. The data used are obtained from their annual reports.

COMPARISON WITH EUROPEAN BANKS CHART II.5

Sample of large banks



SOURCE: Institutions' annual reports.

Large Spanish banks also have the highest *PERs* among the largest listed European banks, reflecting favourable expectations for domestic and international operations, in an economic environment of strong growth (Chart II.5.D). In most countries, however, there was a slight fall in PERs in 2004, relative to their level in 2003, except among German institutions where they rose considerably, in line with the improvement in their results.

III Solvency

III.1 General situation

During 2005, the solvency ratio of Spanish deposit institutions was characterised by the high growth of its components, driven by the strength of activity, as a result of the acquisition of a large British institution in late 2004, the effects of which were already apparent in the last issue of the FSR, and by the introduction of the new accounting criteria established by CBE 4/2004[1]. The *total solvency ratio* has fallen slightly (25 bp), to around 10%. The fall has been more marked (60 bp) under the *Basel rules* although, being less restrictive than the Spanish rules, its value stood in June 2005 at 11.7%. The *tier 1 ratio* fell to 7.5%, down 36 bp from June 2004. This was still well above the minimum required level of 4% (Chart III.1A)[2].

Capital requirements and capital both accelerated in the first half of 2005. While the former rose by 29.2%, as a consequence of the acquisition of a British bank and the ongoing dynamism of Spanish operations, the latter rose by 26% (Chart III.1B). Although this rise in capital was a very significant acceleration, it was not enough to fully offset the larger capital requirements arising from the greater risk assumed during the year, so that the solvency ratio declined.

Capital was boosted both by tier 1 capital (23.3%) and also by the large increase in tier 2 capital (24.1%), as well as by smaller deductions, which fell by 34.8%.

Although *Tier 1 capital* accelerated by 16 pp, it continued to lose weight within total capital to the benefit of tier 2 capital (74.3%, 1.5 pp less than a year earlier). Underlying this decline was the behaviour of reserves. Their acceleration (22.9%, four times the increase in June 2004) was responsible for the acceleration in tier 1 capital, given their weight of 83.7% within its positive components. This situation is explained by the transferring to reserves of the profits obtained by institutions and, especially, the increases in capital that were carried out. At the same time, goodwill, which increased by 10.8%, had an adverse effect on tier 1 capital, given its high weight within the deductions from tier 1 capital (88.6%). In addition, there was the effect of the application of IFRS, which led to a 52.6% reduction in the reserves of consolidated companies and a 95.5% decline in their losses, since (as explained in Chapter 1) a significant number of associates are now included in the available-for-sale portfolio and no longer presented as investments. These two factors practically cancelled each other out so that their net effect hardly contributed to the total change in tier 1 capital (Chart III.1C).

Tier 2 capital accelerated by 6.8 pp, owing to the recourse to subordinated financing (which grew by 13.1%, 5.4 pp less than in the previous year) and, equally, to the significant contribution of the revaluation reserves, which quadrupled (Chart III.1D). The latter reflects the application of CBE 4/2004 which allows institutions, under certain conditions, to use fair value to measure any element of their tangible assets, when the Circular is first applied (1 of January 2004), and to transfer the adjustments of this valuation (in this case positive) to revaluation reserves.

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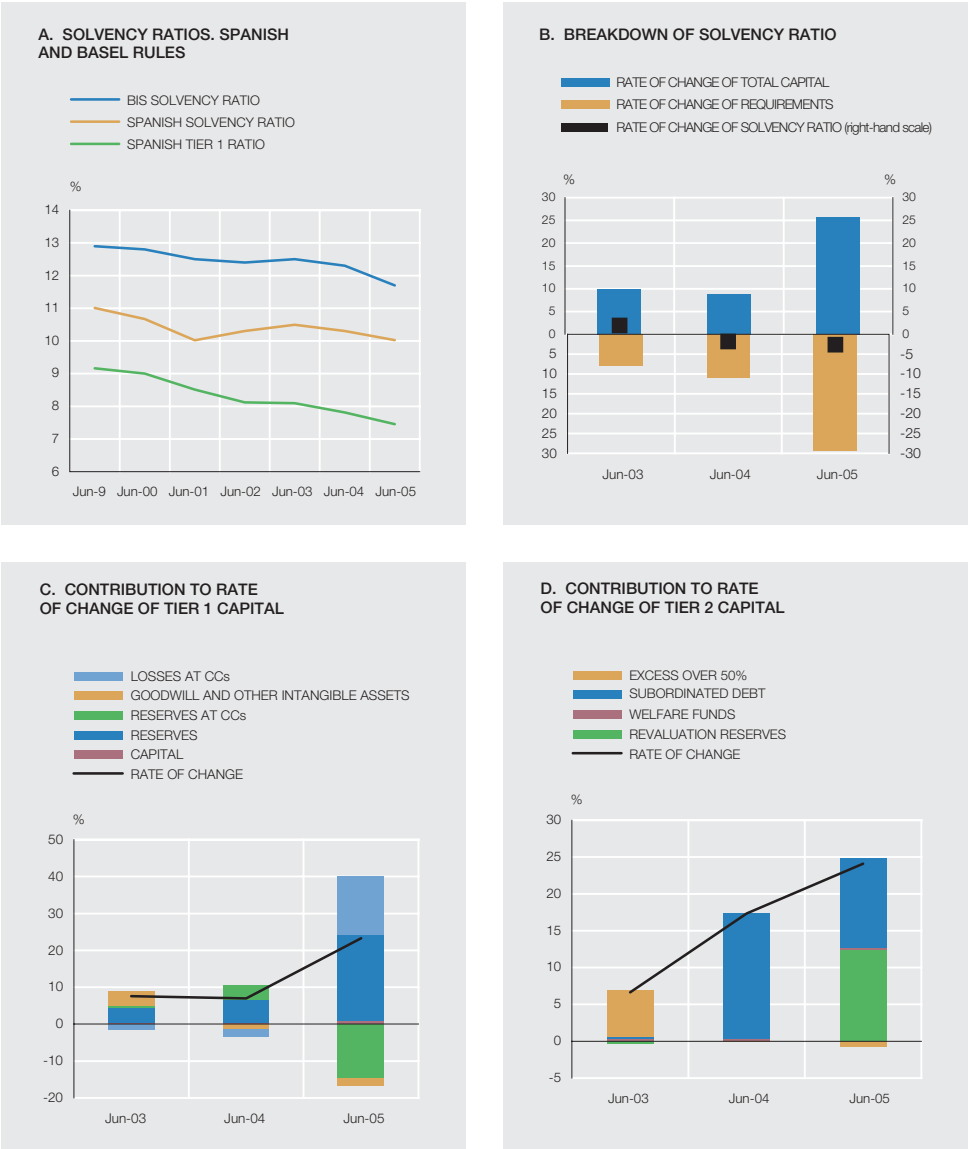
1. The significant reform of the rules according to which the annual accounts of credit institutions are prepared, undertaken by CBE 4/2004, explains why CBE/1993, the culmination of the Banco de España's development of the law on capital and supervision on a consolidated basis of credit institutions has been amended by CBE 3/2005 of 30 June 2005, without altering either the current definition of eligible capital, or in a substantial way, the accounting basis for calculating risk. **2.** Such declines may be reversed, at least partly, when the analysis and discussion of the eligibility as regulatory capital of the hybrid instruments of the above-mentioned acquired British institution are finalised.

SOLVENCY RATIOS AND CHANGE IN CAPITAL CHART III.1

Deposit institutions



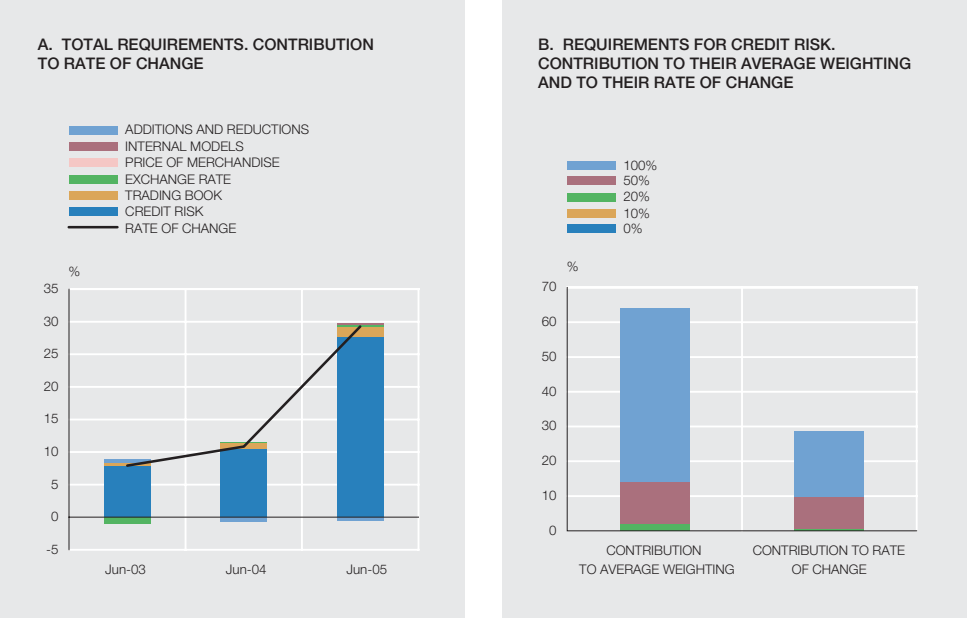
SOURCE: Banco de España.

Finally, *deductions,* the third element of capital, declined (by 26.3%) owing to the indirect effect of the increase in capital, since there was a significant increase in that which serves as the basis for the limit on holdings of non-financial entities, which enabled more of these to be computed without capital having to be reduced as a result.

Risk-weighted assets, and thus requirements, rose by 29.2% owing to the considerable growth in loans and receivables, given the strong performance of the Spanish economy and, in particular, of the Latin American economies, and also because of the larger requirements resulting from the acquisition (referred to above) of a British institution in the second half of 2004 (Chart III.1B). As regards the importance of the requirements, those associated with credit risk stand out, with an acceleration of 18.2 pp to growth of 29.3% (Chart III.2A). Among the latter, the classification of exposures by risk group, which are assigned a weighting according to the counterpart sector and security involved, enables the average weighting of the portfolio subject to such requirements to be calculated. Thus, the profile of this portfolio remained practically unchanged since its average weighting was 64.1%, only 70 bp more than in June 2004

REQUIREMENTS CHART III.2

Deposit institutions



SOURCE: Banco de España.

(Chart III.2B). The large increase (60%) in risks with a 50% weighting, mostly mortgage loans, stands out. The higher relative weight of those with a weighting of 100% means that their growth (23.2%) contributed significantly to the growth of total credit risk requirements.

With regard to requirements calculated using internal models, a possibility permitted for all risks other than credit risk since the entry into force in December 2003 of CBE 3/2003, only two institutions have used such models to date. In June 2005, only 4.2% of all the requirements capable of being computed by means of internal models were so computed.

III.2 Analysis based on individual institutions

Separate analysis of commercial banks and savings banks enables the effect that acquisitions have had on the solvency ratio of the former to be distinguished. The fall in the solvency ratio of credit institutions is seen to have occurred as a result of the 65 bp decline in the total solvency ratio of commercial banks (to 9.1%), since the ratio of savings banks stood at 11.2%, up slightly from June 2004. Accordingly, the difference between the total solvency ratios, under Spanish rules, of these two groups of institutions increased to 2 pp. In the case of the commercial banks there were also declines in the solvency ratio according to the Basel rules (10.8%, after a fall of 1.2 pp), and in the tier 1 ratio (6.8%), which underwent the smallest decline (40 bp). As regards savings banks, their tier 1 ratio also fell, for the fifth year running (by 19 bp to 8.1%), while their Basel ratio rose by 20 bp to 12.8% (Chart III.3A).

The reduction in the solvency ratios of *commercial banks* occurred as a result of the sharp increase in requirements (34.9%), a consequence of the acquisitions made last year, and despite the buoyancy of capital (25.9%), which grew almost 5 times more than in the period to June 2004 (Chart III.3.B). All three components of capital made positive contributions. Firstly, tier 1 capital accelerated significantly (27.3%), driven by reserves (30.5%), the increase in the capital of a large institution contributing to this behaviour. However, the parallel increase in goodwill (30.5%) checked the growth of tier 1 capital. In addition, as already mentioned, the application of CBE 4/2004 has led to movements in reserves and in the losses of consolidated companies with a small overall effect (Chart III.3C). Secondly, tier 2 capital decelerated (7.7%)

SOLVENCY RATIOS AND CHANGE IN CAPITAL CHART III.3

Commercial banks and savings banks

SOURCE: Banco de España.

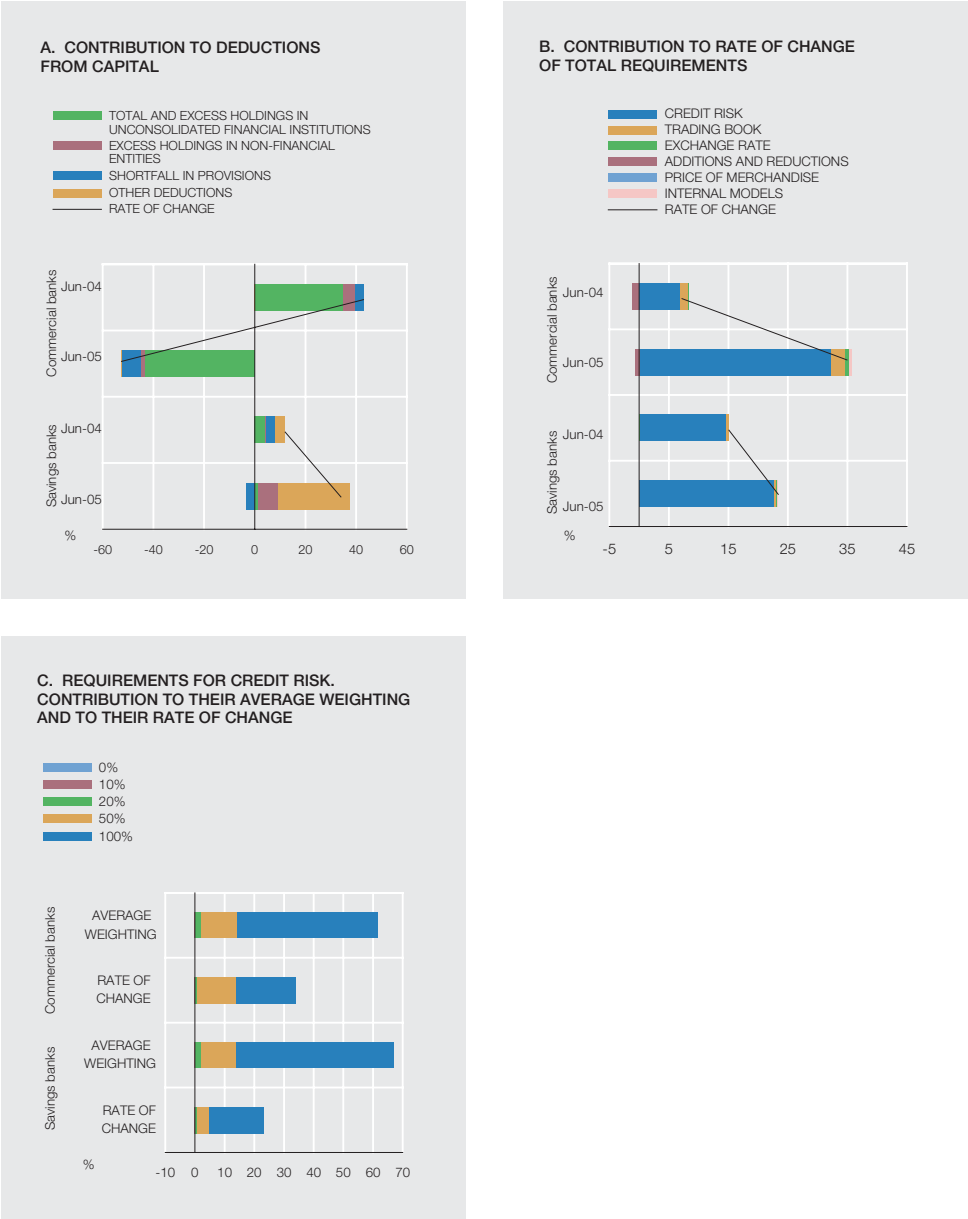
because of the decline in the recourse by commercial banks to subordinated financing (7.3% as against 19.4% in the previous year) (Chart III.3D). Thirdly, the larger amount of tier 1 and tier 2 capital entailed smaller deductions in respect of those investments in financial institutions not forming part of the consolidated group of credit institutions that exceed the established limit of 10% of the sum of tier 1 and tier 2 capital (Chart III.4A).

The increase in the size of Spanish banking groups increased risk-weighted assets (which grew by 34.9%), resulting in higher capital requirements (Chart III.4B). In particular, the requirements for credit risk increased significantly owing to the sharp growth in risks with a 50% weighting (101.7%) and also to the higher growth of those with a 100% weighting (24.2%). These developments raised the average weighting of this portfolio to 61.5%, 1.2 pp higher than in June 2004 (Chart III.4C).

As regards the capital of *savings banks,* it accelerated significantly, growing at a rate of 25.7%, more than double the rate recorded the previous year (Chart III.3B). The solvency of these in-

CONTRIBUTIONS TO DEDUCTIONS FROM CAPITAL AND REQUIREMENTS CHART III.4

Commercial banks and savings banks



SOURCE: Banco de España.

stitutions was strengthened by the rapid increase in tier 1 capital (20.5%) as a consequence of their strong results, which was conducive to transfer thereof to reserves (15.4%). Also the sharp amortisation of goodwill (66.6%) reduced intangible assets, so that their contribution to the behaviour of capital was positive (Chart III.3C).

Tier 2 capital accelerated, growing by 41.1%, up from 15.4% in June 2004, owing to the continued issuance of subordinated financing (19.3%, 1.9 pp more than in the same period of the previous year) and, temporarily, as a result of the application of CBE 4/2004, which has entailed an increase in revaluation reserves (431%), as a consequence of recording tangible assets at fair value (Chart III.3D). Finally, deductions accelerated (34%), with an increase in those resulting from an excess of investments in non-financial institutions (38.7%), in line with the larger presence or savings banks in this sector (Chart III.4A).

The strength of the lending activity of savings banks continued to generate higher requirements (Chart III.4B), in particular, for credit risk (23.2%), which have stemmed from the growth in the mortgage market, given that risks with a 50% weighting increased by 24.5%, and in risks with a 100% weighting (23.2%). As a result, their risk profile has risen very slightly to an average weighting of 67.1%, somewhat above that of commercial banks (Chart III.4C).

The *distribution of institutions according to their total solvency ratio* shifted to the right at the lower brackets, especially those below 11%, towards the region of 13% (Charts III.5A and III.5B). As a result of these changes the number and relative weight of institutions in the 8-10% bracket diminished, in favour of higher solvency brackets. The distribution of institutions according to the increase in their solvency ratio underlines this result, since more institutions increased their ratio during this period than in the same period a year earlier, the distribution having shifted towards the right with less concentration around zero (Chart III.5C).

COMPARISON WITH EUROPEAN BANKS

Both the total solvency ratio and the tier 1 ratio of Spanish institutions were slightly below the EU average and the euro area average (Chart III.6A). The significant increase in capital in 2004, especially tier 1 capital, was not sufficient to offset the sharp increase in capital requirements, owing to the growth in activity and the acquisition of a large British institution by a Spanish one. However, as mentioned in the last issue of the FSR, in December 2004, the solvency ratios of Spanish institutions were well above the regulatory minimum levels. The composition of risk-weighted assets (RWA) shows, once again, the higher growth in lending in Spain relative to the EU average, against a background of higher economic growth, and the lower weight of the trading book.

A comparison of large listed European banks shows that, in 2004, Spanish institutions had the highest total solvency ratios, according to the Basel rules, while their position with regard to the tier 1 ratio was less favourable (Chart III.6B). However, the dispersion of both solvency ratios across countries is narrow, and in all cases they are well above the minimum levels required by regulations.

The pay-out ratio of large Spanish banking groups exceeds 50% and is very similar to that of large British banks (Chart III.6C). As already mentioned in Chapter II, both these groups of institutions are among the most profitable in Europe. The large French, Italian and German institutions retain a larger proportion of their profits, although in the latter case one must consider the low level of profits as the main explanation for the level of the pay-out ratio. The institutions of countries with higher pay-out ratios reduced the levels of their ratios in 2004, relative to 2003, the opposite occurring in countries with lower levels. This behaviour is explained by the improvement in earnings in 2004.

RISKS OF FOREIGN FINANCIAL ASSETS

In late 2004, not only did the geographical and sectoral distribution of foreign financial assets change, as explained in Chapter I, but also the geographical distribution of *risk exposure* (one of the better measures of the risk assumed by institutions, obtained as the product of the estimated average probability of default for each country and the assets of the institutions in each country) changed. In 2005, the credit rating of Argentine public debt improved from the default category to B-rated (according to the Standard & Poor's classification). This improvement significantly altered the geographical distribution of the risk exposure of Spanish deposit institutions (Chart III.7A and B).

In addition to the geographical change, there was also a significant fall in the absolute level of risk exposure, despite the growth in assets. Risk exposure fell from €11 billion to less than €6

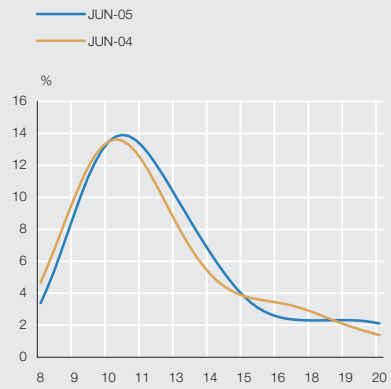
SOLVENCY RATIO DISTRIBUTION CHART III.5

Deposit institutions

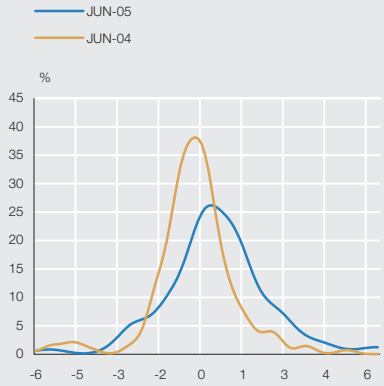
A. BY BRACKET

SOLVENCY RATIO BRACKETS	JUN-04		JUN-05	
	% TA	NO. OF INST.	% TA	NO. OF INST.
<8	0.0	1	0.0	1
8-10	66.8	47	60.8	40
10-12	24.8	55	28.3	52
12-15	6.0	21	9.2	34
15-20	2.1	25	1.3	20
20-25	0.0	4	0.2	7
>25	0.2	19	0.1	17

B. KERNEL ACCORDING TO NUMBER OF INSTITUTIONS



C. KERNEL OF INCREASE (pp) IN THE TOTAL SOLVENCY RATIO ACCORDING TO NUMBER OF INSTITUTIONS



SOURCE: Banco de España.

billion in March 2005 (the latest data available). In terms of capital (Chart III.7.C) the fall was also very notable.

Finally, the *risk profile of foreign financial assets* (defined as the weighted average of the average probabilities of default of each country) continued to decline. This risk profile peaked in 2001 with the default on Argentine debt. Subsequently the risk profile has followed a declining trend, owing to the reduction in exposure to Argentina, expansion in other lower risk areas and the general reduction of risk in a considerable number of countries in which Spanish deposit institutions have a presence. In 2005, with the change in the rating of sovereign Argentine debt and the consequent reduction in its estimated PD, the risk profile index fell further, in particular, in relation to sovereign debt (Chart III.7.D).

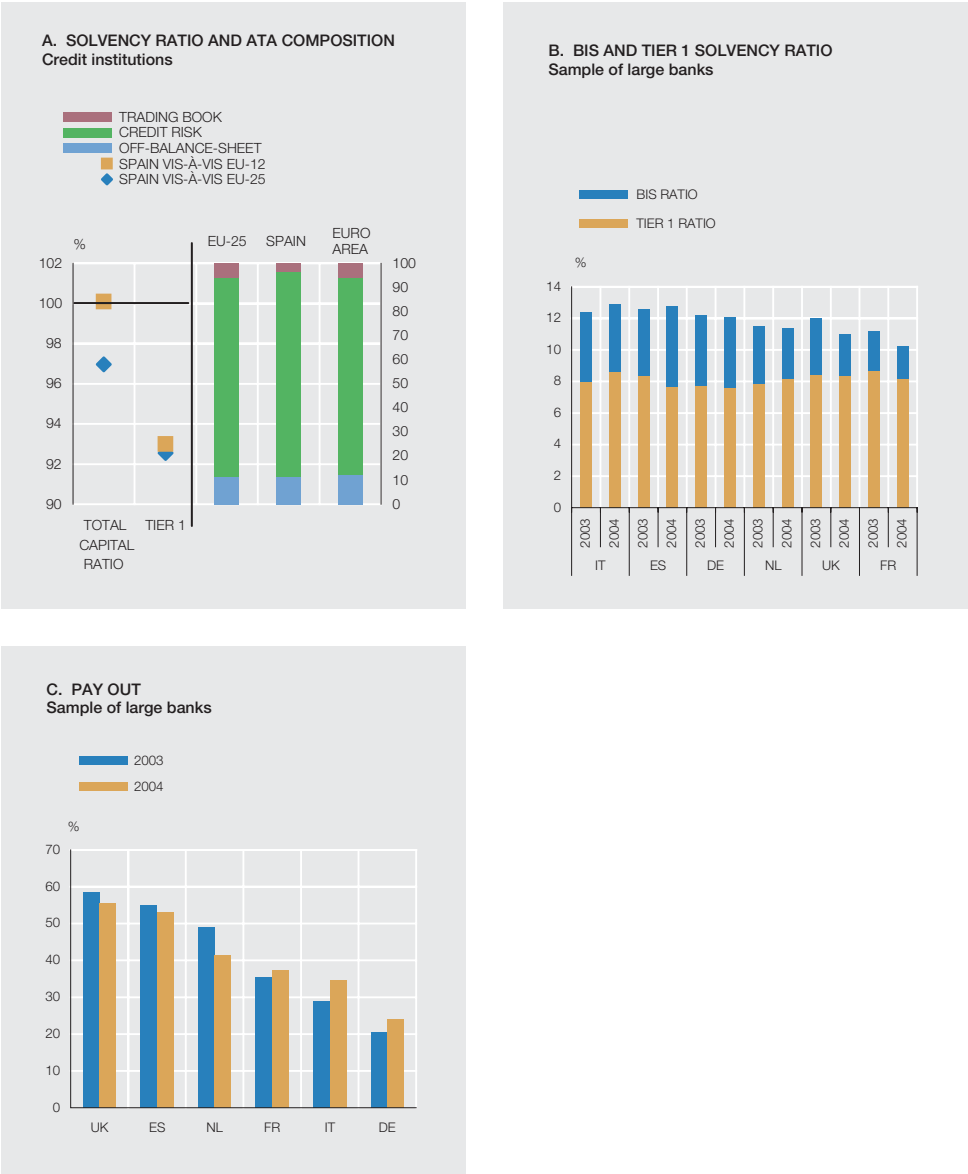
HOLDINGS IN COMPANIES

Deposit institutions invest in capital instruments (shares) for different purposes, including to make a short-term profit from changes in their prices, to receive a steady flow of dividends, and to exploit the potential induced business. These investments are made in different sectors, both industrial and financial. In December 2004, total investments as a proportion of the regulatory capital of deposit institutions stood at their highest level since 1996, reaching 48.4% as

COMPARISON WITH EUROPEAN BANKS

CHART III.6

Credit institutions and sample of large banks



SOURCE: Banco de España.

against 34% in 1996 (Chart III.8A)[3]. Moreover, in 2004 this proportion rose by more than 14%, bringing to an end the continuous decline of the previous three years. Commercial banks have always had a lower ratio than savings banks, except in 2004. There is a high degree of dispersion in this ratio among the 20 largest institutions, by volume of assets, the assets of these institutions representing 80% of the total assets of deposit institutions at the consolidated level (Chart III.8B).

In 2004, the holdings of all deposit institutions were 63.9% of tier 1 capital. Throughout the period they had a very similar profile to holdings as a proportion of total capital; that is to say, the commercial banks until 2003, had a lower ratio than savings banks, this

3. The information used comes from balance sheets and consolidated income statements, in order to avoid holdings in subsidiary credit institutions and to be able thereby to capture the position of the group of deposit institutions as a whole. It includes both financial and non-financial corporations.

RISK OF FOREIGN FINANCIAL ASSETS CHART III.7

Deposit institutions

SOURCE: Banco de España.

a. The data are for December each year, except in the case of 2005, when they are for March, the latest information available when this IEF went to press.

trend being reversed in 2004 (Chart III.8C). The dispersion in company holdings, as a proportion of tier 1 capital, among large Spanish credit institutions is very high (Chart III.8D)

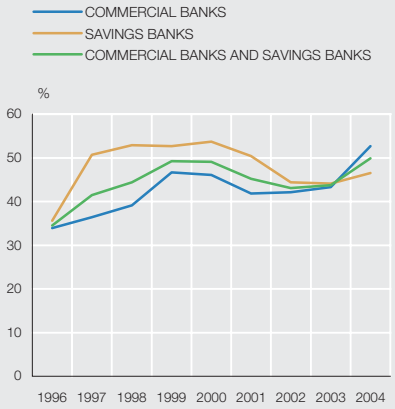
The holdings of credit institutions in companies, in particular those in large (industrial and services) non-financial corporations, introduce an element of risk that must be properly measured by such institutions. A high concentration of risk in a large industrial company may lead to difficulties for the institution if the value of that company undergoes a significant and prolonged fall, as a result, for example, of elements specific to its business or of an adverse shock in financial markets.

Comparing the dividends received on the holdings of institutions with profit after tax, it can be seen that there is a significant difference between the level reported by banks which barely exceeded 15% and that reported by savings banks, which in 2004 stood slightly above 25% (Chart III.8E). This shows the growing importance in the profits of savings banks of the dividends provided by their corporate holdings. In addition, there is a high degree of dispersion in the relative weight of these dividends among the 20 largest institutions (Chart III.8F).

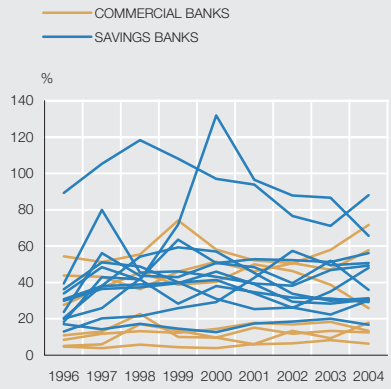
IMPORTANCE OF THE HOLDINGS IN COMPANIES OF DEPOSIT INSTITUTIONS

CHART III.8

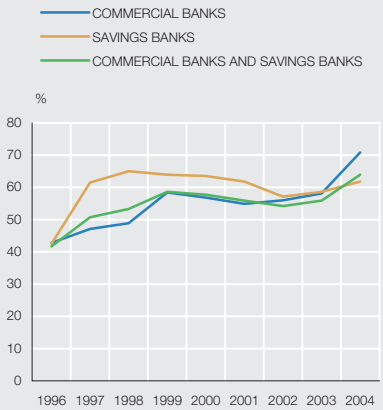
A. HOLDINGS AS A PROPORTION OF REGULATORY CAPITAL. AVERAGE FOR GROUPS OF INSTITUTIONS (%)



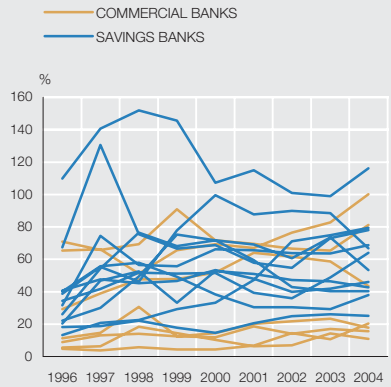
B. HOLDINGS AS A PROPORTION OF REGULATORY CAPITAL. 20 LARGEST INSTITUTIONS (%)



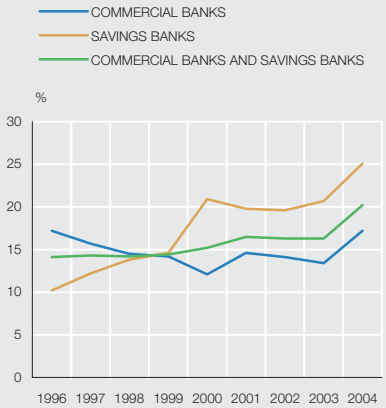
C. HOLDINGS AS A PROPORTION OF TIER 1 CAPITAL. AVERAGE FOR GROUPS OF INSTITUTIONS (%)



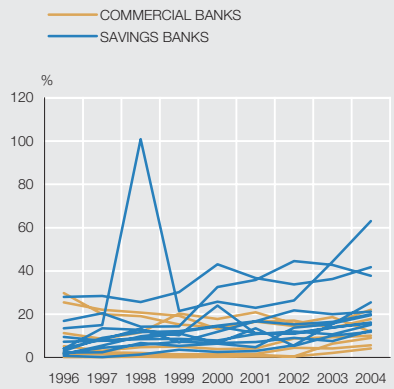
D. HOLDINGS AS A PROPORTION OF TIER 1 CAPITAL. 20 LARGEST INSTITUTIONS (%)



E. DIVIDENDS AS A PROPORTION OF PROFIT AFTER TAX. AVERAGE FOR GROUPS OF INSTITUTIONS (%)



F. DIVIDENDS AS A PROPORTION OF PROFIT AFTER TAX. 20 LARGEST INSTITUTIONS (%)



SOURCE: Banco de España.

BANKING CORPORATE GOVERNANCE

Information transparency is a necessary first step towards achieving greater involvement by the markets in the disciplining of institutions[4], an essential complement to banking supervision. There is nothing new in this requirement, which was reflected in the Core Principles for Effective Banking Supervision formulated by the Basel Committee on Banking Supervision in 1997.

Recognition of the need for action by the markets to complement the task of supervisors in ensuring that institutions are well managed, sound and solvent, has been boosted by the Basel II Capital Accord (June 2004). One of the three pillars on which the new Accord is based is market discipline. Accordingly, Basel II establishes requirements for the public reporting of, inter alia, exposure to the different risks, the valuation models used and the situation of eligible capital and minimum capital requirements.

The need to provide information to the markets[5], so that they can act as an external control mechanism, is also explicitly recognised in the area of corporate governance. In the banking field, where information asymmetries between internal and external agents are greater than in other sectors, the Basel Committee on Banking Supervision argues that, among the principles of sound corporate governance is the need for transparency in its conduct. This is reflected both in its 1999 paper and in the updated version currently under preparation (Box III.1).

Both of the Committee's papers argue that transparency is an essential element for sound and effective corporate governance. This is because when shareholders, other stakeholders and market participants do not receive sufficient information on the structure and objectives of the institution, it is difficult for them to effectively monitor and properly hold accountable the board of directors and senior management.

The Committee identifies various areas in which institutions should disclose information to the public. Notable among them are: 1) board structure (bylaws, size, membership, selection process, qualifications, independence, potential conflicts of interest); 2) committee structure; 3) senior management structure (responsibilities, reporting lines, qualifications, experience); 4) organisational structure (major share ownership and voting rights, major shareholder participation on the board or in senior management, ...); 5) information about the institution's incentive structure (remuneration policies, executive compensation, ...); 6) the institution's code of conduct or ethics, and applicable corporate governance structures; 7) nature of transactions with related parties, including matters for which directors may have interests, either directly or indirectly; and 8) availability of the annual report, which should enable a view to be obtained of the institution's financial situation.

In Spain, in recent years, significant efforts have been made in this direction. In 1998 the *Olivencia Code* for listed corporations stated that the policy of information transparency imposes an obligation to supply information to the market. That information should not solely refer to activities and results, but also to the ownership structure, changes in corporate governance rules, transactions with related parties and capital.

Subsequently, the Aldama report of 2003, principally addressed to listed companies, considered that the information supplied to the market in Spain was basically quantitative, so that a greater scarcity of qualitative information was detected, especially in the area of corporate

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4. Box III.1 of FSR no. 4, of May 2003, analyses market discipline in relation to financial institutions. **5.** The 1999 OECD document, *OECD Principles of Corporate Governance* and its subsequent updated version of 2004 both recognise the importance of information transparency for firms in general.

WORK BY THE BASEL COMMITTEE ON BANKING SUPERVISION IN RELATION TO CORPORATE GOVERNANCE

BOX III.1

Corporate governance is an area that has in recent years been subject to the attention of the national authorities of various countries and of several international bodies. In 1999 the Basel Committee on Banking Supervision published a paper containing a number of recommendations to promote good bank corporate governance[1]. This paper basically complements that published by the OECD[2] that same year, which contains a set of generally applicable principles of corporate governance. The Committee's work related specifically to the banking sector, concentrating on its particularities and attempting to offer a more practical focus.

Since then various events have highlighted failures in the corporate governance systems of a number of organisations. This is one reason why the OECD has revised its previous work, finally publishing an updated version of its principles in 2004[3].

For its part, in December 2004 the Committee set up a working group to analyse this area, with various objectives: 1) to analyse the changes made by the OECD and to assess the extent to which they should be taken into account considering the specific circumstances of the banking sector; 2) to take into consideration those lessons that might be derived from the corporate governance problems 3) to analyse the implications arising from certain activities carried out by credit institutions, in particular, those conducted through structures or in jurisdictions that may entail transparency problems and restrictions on information flows (for example in offshore centres). This work required the co-operation of the banking industry, various international agencies and all interested parties.

On 29 July 2005 the committee published a revised version of its 1999 paper, establishing a three-month public consultation period[4].

The paper considers, firstly, that corporate governance is possibly more important for banks than other companies (among other reasons it highlights their role in the process of financial intermediation and their participation in payment systems, the need to safeguard depositors' funds and the greater sensitivity of banks, owing to their nature, to potential corporate governance failures). It is also argued that the poor governance of an institution may lead to a loss of confidence, a key element in the smooth functioning of the banking sector and, therefore, of the economy as a whole[5].

It is also recognised that corporate governance depends on the existence of an adequate legal, regulatory and institutional framework. Although these factors go beyond the powers of supervisors, the latter are expected to be attentive to possible institutional or legal impediments and to take the necessary steps to avoid them when they have the power to do so.

Hence, and taking into account that legal systems and the specific structures of corporate governance differ considerably from country to country, the Committee proposes a number of *general principles of good corporate governance.*

Firstly, *to establish strategic objectives and a set of values that are communicated throughout the organisation.* Thus, the board, taking into account the interests of all stakeholders (shareholders, depositors, holders of debt, etc) should establish the strategic objectives and ethical standards that will direct the activities of the institution or, in other words, promote a corporate culture that mandates and provides incentives for ethical behaviour. This process shall be defined at the highest level and afterwards communicated throughout the organisation.

When establishing these values, the advantages of timely discussion of problems should be recognised and, therefore, employees should be able to freely communicate possible illegal practices or unethical behaviour. The channels established for this process should provide for anonymity and the adequate protection of those who use them.

It is also the board's responsibility to identify potential conflicts of interest (that may arise for various reasons), to prevent them whenever possible or manage and appropriately disclose them.

The board should ensure that managers implement policies and procedures that promote professional behaviour and integrity, prohibiting activities that diminish the quality of the bank's corporate governance. Also, an effective compliance function should be maintained that monitors compliance with rules and regulations.

Second, it is necessary *to set clear lines of responsibility throughout the organisation,* since their absence may exacerbate any problems that may arise. The board is responsible for overseeing management's actions, while the latter is responsible for delegating responsibilities to the staff and establishing a management structure that promotes accountability and for overseeing such structure.

In this respect, when banks form part of a financial group further challenges arise, for example to the extent certain functions are outsourced (internal audit, risk management etc.) or conflicts of interest arise among the entities within the group. In any case, the same general principles contained in the paper have to be applied. In the group, the parent company determines strategy and general policy, and the structure of corporate governance of subsidiaries that best serves the interests of the group, without forgetting that the board of the banking subsidiary maintains responsibility for the good corporate governance of the bank. This includes its soundness and the protection of the interests of the depositors.

Thirdly, it is necessary to *ensure that board members are qualified for their positions, have a clear understanding of their role in the corporate governance of the institution and are able to exercise independent judgment.* The board members are ultimately responsible for the financial position of the institution and therefore must have appropri-

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1. Enhancing Corporate Governance for Banking Organisations, Basel Committee on Banking Supervision, September 1999. **2.** OECD Principles of Corporate Governance, June 1999. **3.** OECD Principles of Corporate Governance, April 2004. **4.** http://www.bis.org/publ/bcbs117.htm. **5.** A detailed analysis of the specific features of the governance of banks may be seen in the paper by V. Salas: "El gobierno de la empresa bancaria desde la regulación", in *Estabilidad Financiera,* no. 5, pp 197-228, Banco de España.

ate characteristics to assume that responsibility. Also, the institution should have an adequate number and appropriate composition of directors who are capable of exercising judgment independent of the views of management or outside interests. It is recognised that many institutions have found it beneficial, in organisational terms, to establish certain committees, including members who are considered to be independent, to advise the board (inter alia, audit, risk management, compensation and nominations committees).

Fourthly, it is necessary *to ensure that there is appropriate oversight by senior management.* The individuals concerned should have the necessary skills to manage the business under their supervision, and also appropriate control over the key employees in each area. It is important that, under the guidance of the Board, they establish an effective system of internal controls.

Fifthly, corporate governance is strengthened when *the work performed by the internal and external auditors is effectively used.* The board should recognise the importance of the work performed, insofar as, for example, it enables problems with internal control and risk management systems to be identified, and it ensures that the financial statements fairly represent the entity's financial position. It is for this reason that the paper establishes a number of actions that the Board and managers may take to promote the effectiveness of these controls (enhancing their independence, considering rotation of external auditors, etc.).

Sixthly, *the compensation policy should be consistent with the entity's ethical values, objectives and strategy.* Failure to link the structure of incentives for members of the board and managers to the entity's long-term business strategy may result in actions that run counter to the interests of the bank and its stakeholders (shareholders, depositors, etc.).

Seventhly, the need is stressed for *corporate governance to be conducted in a transparent manner.* In fact, according to the paper, transparency is essential for sound corporate governance since, in its absence, it is not possible to monitor the actions of directors and managers. Among other considerations, certain areas are specified in relation to which public information should be provided (for example, the structure of the board, the basic organisational structure of the entity and its code of conduct).

The last principle included in the paper establishes that *entities must know their own operational structure ("know-your- structure"), including their operations in jurisdictions, or through structures, that prevent transparency*[6]*.* The Committee recognises that operating in such jurisdictions or through this kind of structure is normally legitimate and appropriate, but involves additional legal, reputational and financial risks that may make it impossible for the board and the managers to perform adequately their task of oversight of the business, and may hinder effective banking supervision. In addition, institutions must also give special attention to certain products or services developed for their customers, since the illegal or unethical use of these products by customers may pose significant legal and reputational risks to banks.

As a result of these considerations, the Committee specifies that, when activities are carried out in this type of jurisdiction or using such structures, the board should have in place policies and procedures to ensure that the relevant laws and regulations are complied with, that the necessary limits are set and that the appropriateness of these operations is considered, and that the managers identify and manage all the associated risks.

The Committee, having established this broad set of principles of good corporate governance, and recognising again the primary responsibility of directors and managers in corporate governance, specifies that other interested parties should also play a role, including shareholders, auditors, banking industry associations, governments, banking supervisors, regulators and employees.

As regards *banking supervisors,* it is established that they should be aware of the importance of corporate governance and its impact on the performance of banks. Also, they should determine whether the bank has appropriate corporate governance policies and practices, assess the internal controls established and alert institutions when they detect problems during supervision processes. Also, they shall promote good corporate governance by reviewing and evaluating the implementation of the principles set forth in the paper.

6. The Banco de España, in its *2003 Report on Banking Supervision in Spain,* made public a number of principles on "credit institutions' policy on international expansion through offshore establishments".

governance. As a result, it recommended that reporting requirements cover corporate governance structures and practices. More recently, a new initiative has been launched to reflect on corporate governance.

Among other recommendations, the *Aldama Report* suggested that company boards should be required to prepare a *corporate governance report.* It also recommended that these reports should have a uniform structure of presentation to facilitate their comparison by information recipients. A set of basic areas that the reports should cover was indicated, and these are described below.

In relation to the ownership structure, the objective would be to offer a true, fair and up-to-date view of the control of companies. This requires disclosure of the capital structure, specifying percentage holdings and any family, commercial, contractual and corporate relationships that may exist. It is considered important to provide information on shareholders' agreements and control structures.

As for the company's management structure, it is recommended that information, and an explanation and assessment of the practices followed, be provided on the functioning of the Board and the Committees reporting thereto, including their membership, election procedures and rules of operation. Also, markets would benefit from knowing the identity, professional qualifications and functions of board members, as well as their remuneration, capital holdings, the relationships between the latter and the reference shareholders and the existence of cross directorships with other companies.

For related-party and intra-group transactions, in addition to what is established by the Financial System Reform Measures Law of 22 November 2002, in relation to the transactions of a company with its reference shareholders and its directors and senior management, it is recommenced that information be offered on transactions with subsidiaries and generally on those matters that jeopardise the obligation of loyalty.

As regards the risk control systems, information should be supplied on the risk policy, and on the mechanisms for assessing and reducing risks.

As for the operation of the general meeting, it is necessary to disclose the rules governing its operation, and provisions relating to the delegation of voting or to the procedures for meetings (questions, complaints, attendance, etc.).

Law 26/2003 of 17 July 2003, known as the *Transparency Law,* sets out in its Article 116 the obligation to prepare a corporate governance report for listed public limited companies, with a minimum content that basically coincides with the recommendations of the Aldama Report. Moreover, having regard to the latter, an additional chapter is included requiring entities to disclose the degree of compliance with the existing corporate governance recommendations, explaining any deviations therefrom.

The above-mentioned law extends the obligation to prepare a corporate governance report to entities issuing securities listed on an official secondary market, adapting the structure of the report to the specific legal nature of the entity concerned. Order ECO/354/2004 of 17 February 2004 and CNMV Circular 2/2005 determine the minimum content of the reports of *savings banks*[6]*,* maintaining aspects similar to those already mentioned for listed public limited companies (e.g. information on related-party and intra-group transactions, systems to control risk or the degree of implementation of the good governance recommendations), while others are modified as necessary. Thus, for example, information is requested on: 1) the structure and functions of the governing bodies of savings banks; in particular of the General Assembly, the Board of Directors (including supporting bodies, such as audit, remuneration and investments committees) and the Control Committee; 2) The loan, guarantee and security agreements entered into by savings banks in favour of members of the Board of Directors or of the Control Committee, and with their relatives or firms they control and, in particular, in favour of political groups with representation in local government or on regional legislative assemblies that have

6. Savings banks that do not issue non-voting equity units traded on official securities markets are exempted from the obligation to complete certain sections of the corporate governance report.

Different countries have adopted different approaches when organising the regulation and supervision of the provision of financial services. These approaches can be grouped into three major types: 1) an *institutional approach,* in which regulation and supervision are organised according to the type of institution (bank, insurance company, etc.), irrespective of the composition of its business; 2) a *functional approach* focused on the lines of business pursued (life assurance, fund management, etc), without taking into account the type of institution; and 3) *objective-oriented regulation,* where the organisation reflects the objectives of the regulation (stability of the financial system, customer protection, etc).

The institutional approach is the most traditional of the three. However, some critics of this approach argue that the progressive disappearance of differences between the business of financial institutions and products means that under this approach similar activities may be treated differently when they are carried out by different types of institution. At the same time, critics of a purely functional approach argue that it may mean that no regulator is responsible for the prudential supervision of the institution as a whole.

In the mid-1990s, Taylor and Goodhart proposed objective-oriented approaches for regulation and supervision[1]. The *"twin peaks"* model defended by Taylor proposed, on one hand, a Financial Stability Commission with responsibility for the prudential supervision of most financial institutions, whose objective would be to ensure the solvency of the financial system as a whole and to oversee the risks of all types of financial institution. On the other hand, he proposed a Consumer Protection Commission responsible for monitoring the conduct of financial institutions with respect to their retail customers. Goodhart also argued in favour of separating the two central objectives of regulation of the financial system: systemic stability and investor protection. However, he argued that both objectives were jeopardised by the insolvency of financial institutions and would benefit from measures aiming to protect such solvency. Accordingly, a certain overlap would be necessary between the two regulatory and supervisory authorities concerned. Taylor argued that the twin peaks approach: i) would reflect the differences existing between the style and techniques of prudential regulation and those of the conduct-of-business regulation; ii) would eliminate the duplication and superimposition of regulation; iii) would create regulatory authorities with precise objectives; iv) would establish mechanisms to resolve conflicts between the various objectives of financial services regulation; and v) would stimulate an open, transparent regulatory process subject to parliamentary scrutiny through the reports that the two independent Commissions would be required to present periodically.

However, the twin peaks model has been criticised by those who favour an integrated (single authority) approach to regulation and supervision. They argue that the distinction between regulatory objectives is not so clear in practice and that a large number of institutions would need to be regulated by both authorities, with the consequent inefficiencies and potential problems of communication, cooperation and consistency. Moreover, they consider that, conceptually, there is considerable overlap because both authorities are interested, for example, in having as detailed a knowledge as possible of the managers of the institutions. Others consider the twin peaks model too general and that it fails to recognise the differences between institutions and types of business, both in relation to prudential regulation and the regulation of vis-à-vis customers.

The Netherlands has recently restructured its regulatory system in line with the twin peaks approach. The central bank has retained its responsibility for systemic stability and the payments system as well as for the prudential supervision of deposit institutions, and has acquired responsibility for the prudential supervision of mutual funds and securities firms. In addition, in 2004 the central bank also assumed responsibility for supervising insurance companies and pension funds. At the same time, the securities markets and the conduct of business of all financial services providers are the responsibility of another authority. Among the reasons cited for adoption of the twin peaks approach in the Netherlands are: the increasingly blurred boundaries between the different types of financial intermediary (banks and insurance companies in particular), partly on account of the increase in the complexity of financial products; the existence of significant financial conglomerates, with banks and insurance companies and significant asset management business; and the high relative weight of insurance companies in the Dutch financial system[2]. Application of the twin peaks approach was preceded by a period of increasing coordination between the banking and insurance supervisors through a cooperation protocol to ensure adequate supervision of financial conglomerates. It should be noted that, unlike other countries, the change in the model of organisation of the supervision of the financial system in the Netherlands was not made in response to a banking crisis or a crisis affecting other financial intermediaries, with the inevitable loss of reputation that this would have entailed for the supervisor, but in response to the changes in the financial industry mentioned above.

1. M. Taylor (1995): *Twin Peaks: A regulatory structure for the new century,* Centre for the Study of Financial Innovation, London, and C. Goodhart (1995): *Some regulatory concerns,* Financial Markets Group, London School of Economics.

2. See, *New architectures in the regulation and supervision of financial markets and institutions: the Netherlands,* H. Prast and I. Van lelyveld. DNB Working Paper 21, December 2004.

participated in the electoral process of the savings bank. Information is also required on the situation with respect to default on loans granted to these groups and loans to public institutions that have appointed general managers; 3) the group's business structure, with details of the role of each institution in the group and the geographical distribution of branches; 4) the annual report of the Investments Committee and a summary thereof indicating the acquisitions and sales of qualifying holdings in companies, as well as investments and divestments in cor-

porate projects when it has a presence in their management or in their governing bodies; and 5) the non-voting equity units issued.

In short, the corporate governance report is in line with the initiatives and recommendations at the international level for improving corporate governance by promoting information transparency and thereby boosting market discipline. Indeed, the Transparency Law is an ambitious measure that covers a large part of the transparency recommendations contained in the Basel Committee's consultative document[7].

Box III.2 analyses different ways of organising the regulation and supervision of the provision of financial services.

7. The corporate governance report is one channel for the communication of qualitative information to the market, but not the only one. Section Five of Chapter IV of Title I of CBE 4/2004 is devoted to the Explanatory Notes. These Notes complete, expand and comment on the information contained in the financial statements. They are a key element in the new accounting circular and will make a decisive contribution to enabling information users to assess institutions adequately, appreciating the risks of their activity.

ANNEX: EXPLANATORY NOTES AND GLOSSARY

1 Explanatory notes

Much of the financial stability analysis conducted in this Report, particularly the study of the balance sheet, risks and profitability of deposit institutions, is based on the information provided by the financial statements required under the accounting circulars of the Banco de España (CBE): CBE 4/1991 to June 2005 and CBE 4/2004 thereafter. The analysis of solvency draws mainly on the information from the statements under CBE 5/1993, on minimum own funds. This Circular has been adapted to CBE 4/2004 by CBE 3/2005, which came into force in June 2005.

The accounting Circular provides information from various perspectives. Thus the information according to the subject represented may be individual or consolidated, combining with that provided according to the end-user targeted, i.e. public information, for general dissemination, and confidential information for the supervisor. Moreover, the confidential information on total business is broken down into business in Spain and business abroad.

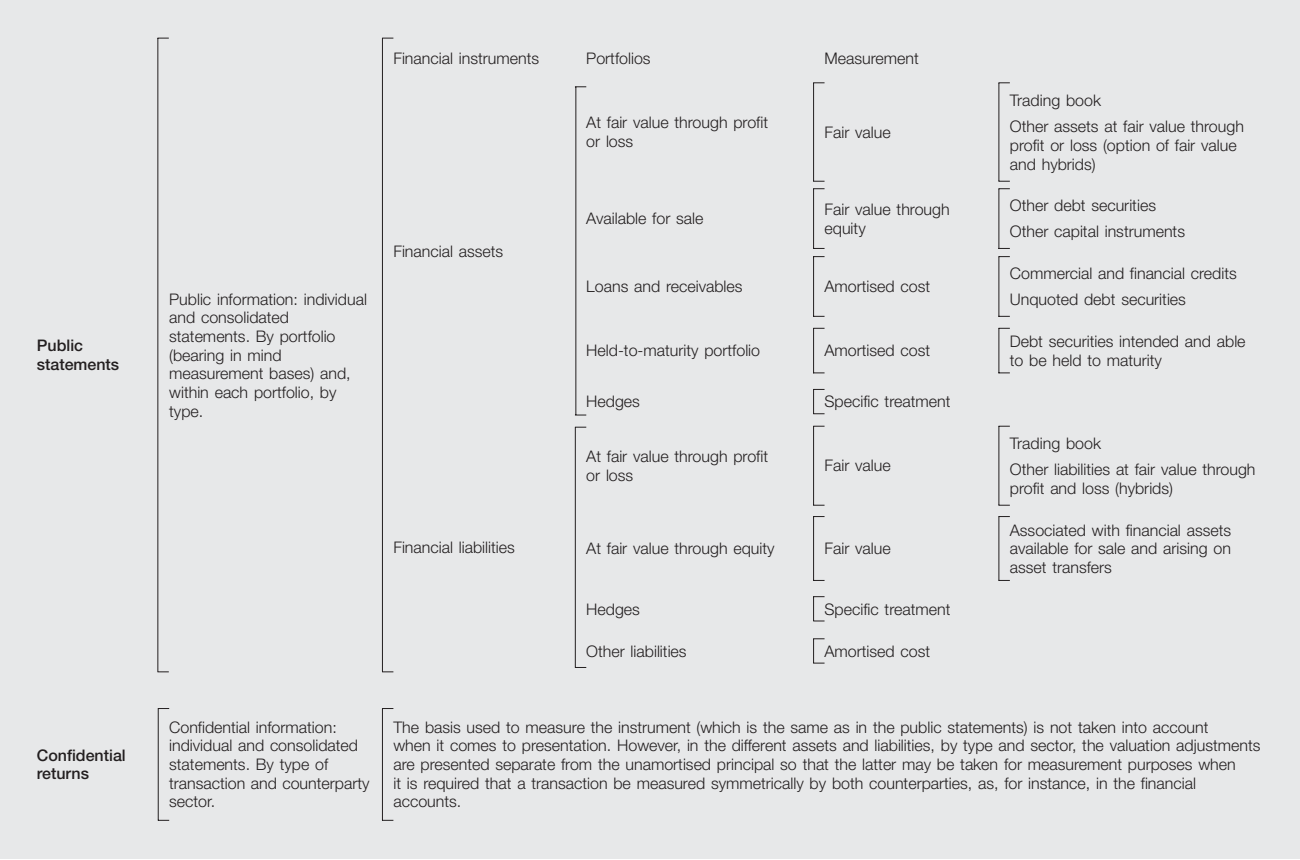
Public information has a general aim and, therefore, is directed at users in general. Under CBE 4/1991, these users were chiefly considered to be the management of the bank itself, the employees, the authorities and market agents, while CBE 4/2004 considers investors to be the main user since, if investors' information requirements are met, focusing on risk and profitability, many of the information requirements of the other users will be covered. The financial information provided by the confidential statements has supervisory and/or statistical ends.

Under CBE 4/1991 both the public and confidential consolidated returns referred to the same consolidable groups of credit institutions, i.e. owing to their supervisory end, they referred to the same consolidation groups and with the same scope as those pertaining to the minimum own funds circular. Accordingly, the scope of application for the analysis of balance sheets, risks and profitability of the accounting circular was the same as the analysis of risks and solvency of the minimum own funds circular.

Regulation (EC) 1606/2002 and the Commercial Code state that companies whose securities have been admitted to trading on a regulated market of any European Union Member State must, from 2005, file their public consolidated accounts in accordance with International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS).

The aim of CBE 4/2004, which adapts the financial reporting standards of the EU, is that there should not be different accounting standards for different credit institutions competing against one another and subject to the same banking regulations and supervisory regime. To do this, and so that these institutions' accounts should be homogenous, comparable and aggregatable, the Circular has extended the application of these standards to the public statements (balance sheet, income statement, statement of changes in equity and cash flow statement) of all credit institutions, with quoted securities or not, and to both their consolidated and individual accounts. However, individual and consolidated confidential returns, which are not intended to provide general information but are for supervisory and statistical ends, do not present financial instruments in the same way and do not have the same scope of consolidation as public statements, although the bases for measuring and recording transactions and the definition of the financial instruments are the same in both statements and are, therefore, consistent with one another.

DIFFERENCES IN THE PRESENTATION OF FINANCIAL INSTRUMENTS BETWEEN PUBLIC STATEMENTS AND CONFIDENTIAL RETURNS UNDER CBE 4/2004 FIGURE 1

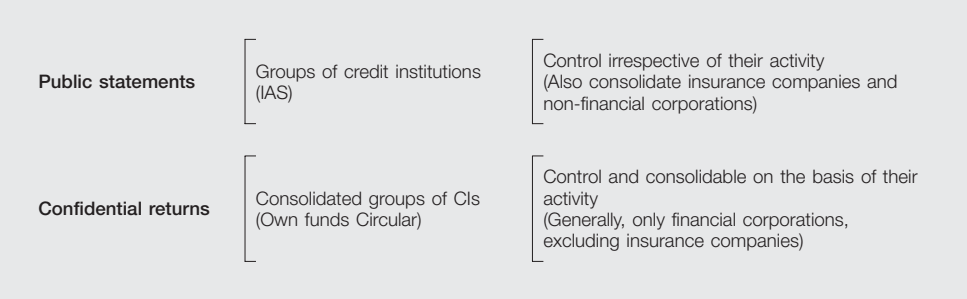


The new Circular, for both individual and consolidated public statements, presents financial instruments in accordance with IAS, i.e. by portfolio, bearing in mind the principle by which they are valued, and, hereunder, by type. In the case of confidential returns, it presents them by counterparty sector and type of transaction. In the confidential returns, unlike the public statements and for statistical reasons, asset and liability valuation adjustments are separate from unamortised principal, which allows for an analysis of the changes over time in the various captions not affected by changes in the value of financial instruments or in the portfolio in which they are recorded (Figure 1). CBE 4/1991 measured financial instruments at unamortised principal, and in a symmetrical fashion for assets and liabilitiies. Since the confidential returns of CBE 4/2004 enable this measurement to be segregated, the statements of both circulars can be linked in respect of a very significant portion, in quantitative terms, of the balance sheet (mainly loans and deposits).

Nonetheless, the measurement bases are common to the public statements and confidential returns alike, although in the latter, as said, valuation adjustments are presented separately from unamortised principal so that they may also be measured in accordance with this principle. In sum, and without taking into account each and every circumstance, financial instruments may be said to be measured: 1) at fair value, in the case of financial assets and liabilities in the trading book or financial derivatives, and available-for-sale financial assets; 2) at amortised cost, in the case of loans and receivables and held-to-maturity investments, and other financial liabilities (Figure 1).

The scope of consolidation also differs between public statements and confidential returns. Thus, in accordance with IAS, consolidated public statements apply to groups of credit institu-

DIFFERENCES IN THE SCOPE OF CONSOLIDATION UNDER CBE 4/2004 FIGURE 2



tions in which all the institutions belonging to the group consolidate their accounts, irrespective of their activity (i.e. insurance companies and non-financial corporations also consolidate), while confidential consolidated returns apply to consolidable groups of credit institutions, i.e. those companies consolidable on the basis of their activity, generally all financial corporations except insurance companies. Accordingly, the consolidation groups of the confidential returns of CBE 4/2004 coincide with those of CBE 4/1991, which allows them to be linked, and also with the consolidation followed by the own funds circular. This consolidation is more useful for supervisory purposes, and also gives consistency to the scope of application of both standards (Figure 2).

Application of the IAS and CBE 4/2004 has entailed a forceful break from CBE 4/1991 in terms both of measurement, presentation and scope of consolidation, and of the level of the series of specific headings analysed. Moreover, further to the new Circular, it is important not only to distinguish between the consolidated and individual statements, but also between the confidential returns – the main basis for the FSR – and the public statements which, as seen, refer to a broader field of action or consolidation to which it is also necessary to adhere. This is because public statements are the basis for the information transmitted to the markets and, therefore, this is useful for completing the analysis of the Spanish banking system's stability. As a result of adherence to these different perspectives, the analysis of financial reporting becomes more complicated since a single variable (a ratio, for instance) may be calculated under different scopes of consolidation and with different measurement bases, meaning that, depending on the information source used as a basis, this variable may take different values and, therefore, when it is not from public statements it will be different to the variable published by the institutions themselves.

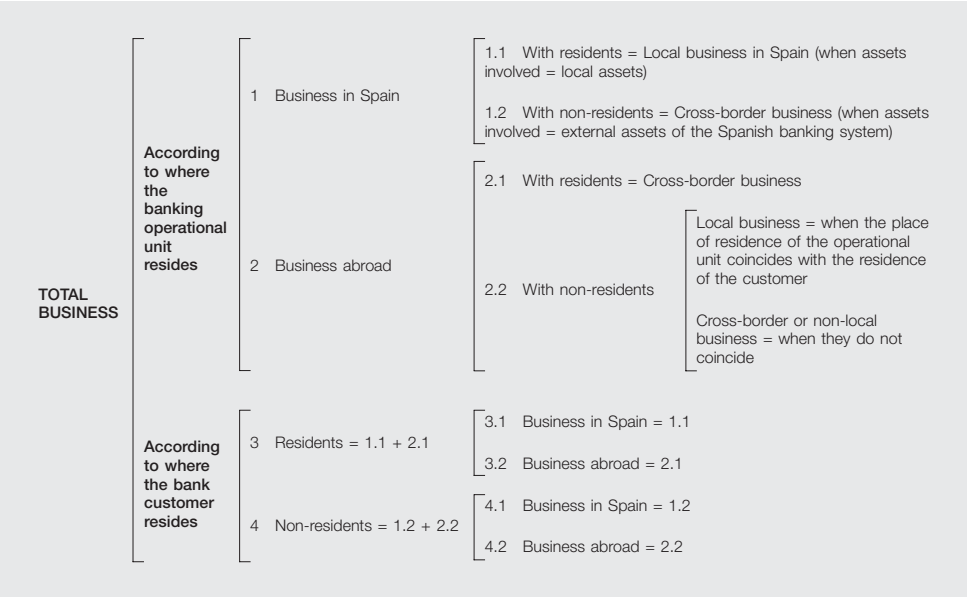
Consolidated confidential returns of consolidable groups of deposit institutions resident in Spain

Aggregation of the consolidated balance sheets or income statements of the consolidable groups of deposit institutions resident in Spain. For those institutions that do not have or belong to a consolidable group, or that are branches of foreign institutions, it is their individual confidential returns are considered for aggregation purposes, while in the case of subsidiaries of foreign institutions, it is their sub-consolidated confidential accounts (those of the group that reports to the subsidiary resident in Spain) that are considered.

The consolidated confidential returns (balance sheet or income statement) comprise the worldwide consolidated total business, with intragroup transactions netted out, of the consolidable groups of institutions considered. These consolidable groups are made up of the parent institution in Spain (with its branches abroad) and its consolidable financial subsidiaries, both in Spain and abroad.

CLASSIFICATION OF ACCOUNTS AND BUSINESS ON THE BASIS OF THE LOCATION FROM WHICH THE INSTITUTION OPERATES AND WITH WHOM IT OPERATES

FIGURE 3



The consolidation and aggregation of the consolidated financial statements of the groups of deposit institutions resident in Spain coincides with that of the solvency or own funds returns, with the exception of the branches of institutions resident in EU countries, which do not provide information on own funds.

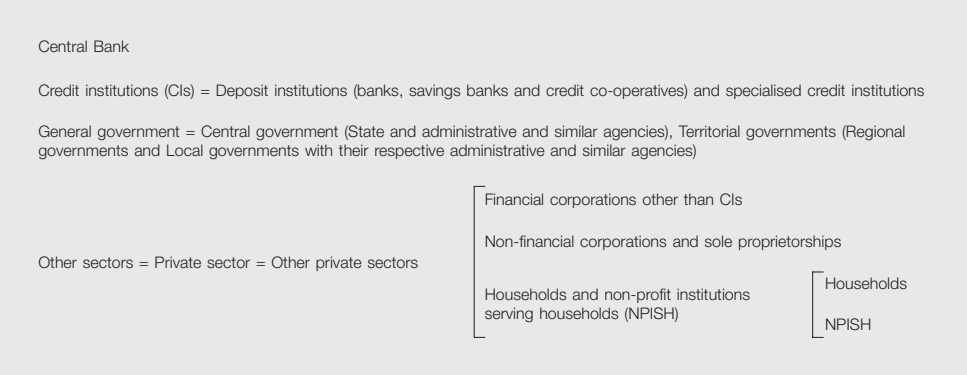
The consolidable financial subsidiaries in the consolidable groups of deposit institutions are those in which control is exercised (control is assumed when voting rights or a share of at least 20% of capital are held) and which belong to one of the following: deposit institutions, specialised credit institutions, securities-dealer companies and securities agencies, investment companies, companies managing collective investment undertakings, companies managing pension funds, portfolio management companies, venture capital companies and companies managing venture capital funds, holders of shares or participations and, finally, institutions, whatever their name or statute, that engage in activities typical of the foregoing (e.g. SPEs and SPVs).

The consolidated accounts of the consolidable groups of deposit institutions residents in Spain may be of national or foreign institutions; in the latter case they will be subsidiaries or branches of foreign institutions.

These statements (total business), as in Figure 3, can be presented on the basis of the location in which the institution's operational unit resides, giving rise to business in Spain or abroad (assets in Spain or assets abroad), or the location in which the counterparty resides, giving rise to the sectorisation of business with residents in Spain and with non-residents (or with foreigners). Moreover, if the residents of the operational unit coincides with that of the counterparty, the reference will be to local business, and if it does not, to cross-border business, non-local business or business abroad.

The consolidation of accounts is based on the control of the group by the parent institution and is essential when analysing the capital integrity and financial stability of a banking system.

CLASSIFICATION OF BOTH THE RESIDENT SECTOR AND THE NON-RESIDENT SECTOR FIGURE 4



Individual financial statements of deposit institutions resident in Spain

Aggregation of individual balance sheets or income statements of these institutions.

The individual statements (balance sheet or income statement) comprise the total worldwide business engaged in by individual deposit institutions resident in Spain. These institutions may be national or foreign (subsidiaries and branches of foreign deposit institutions) and are made up of a central headquarters and all its branches abroad (if any), but they do not include the subsidiaries of these institutions.

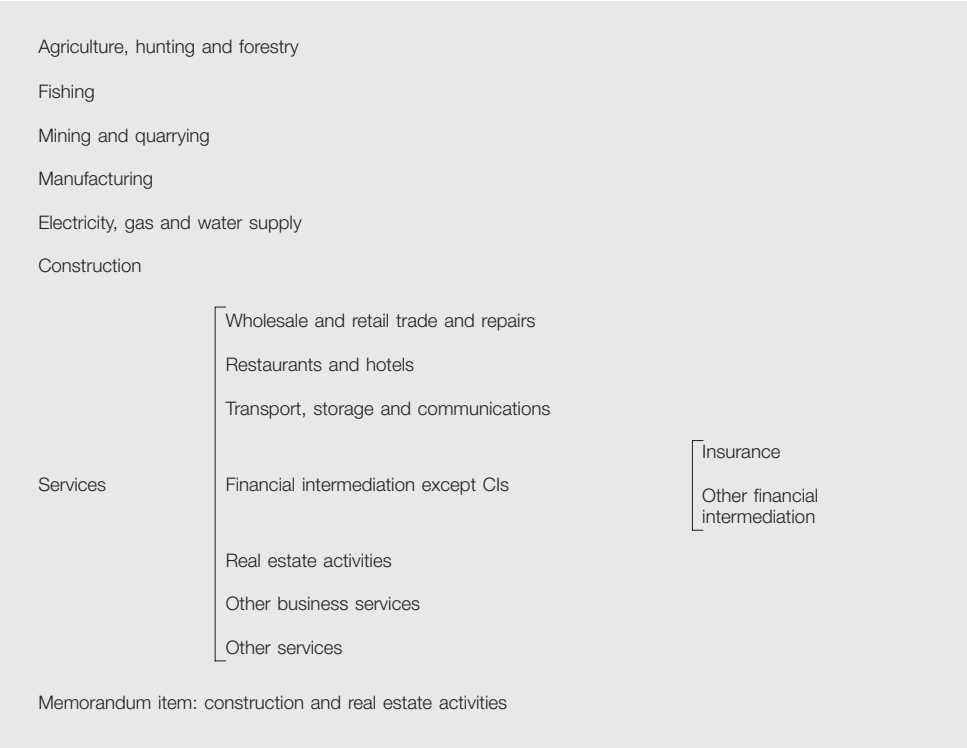
As in the case of consolidated information, the individual statements (total business) can, as observed in Figure 3, be presented using the location in which the operational unit (central headquarters or branch) resides and the location in which the counterparty resides. However, while total business does not include or nets out transactions between units of the institutions residing in different countries, business in Spain and business abroad does not involve a netting out of transactions between the units that reside in these territorial areas: Spain and other countries. In other words, business in Spain includes positions vis-à-vis own branches abroad because they are non-residents and such information is necessary to compile the National Accounts (more specifically the Financial Accounts) and the Balance of Payments, but in total business such transactions are consolidated, as they are assets of some institutions and liabilities of others.

Under business in one country, local business (in the case of Spain, business in Spain with residents), the predominant item of the individual accounts of the institutions that reside in the country, is the basis of the Financial Accounts of said country (Spain) and, therefore, these accounts are linked to the general macroeconomics analysis of the country in question and to the way in which its sectors are financed. Accordingly, there is usually much more information and a greater breakdown of the individual accounts of institutions, as regards their sectorisation, instruments and results, than of the consolidated accounts of their groups.

Institutional sectors. The FSR classifies the institutional sectors featured in Figure 4 as Residents, namely those who have a centre of interest or live in Spain, and Non-residents, those who have a centre of interest or live in a country other than Spain, irrespective of whether they reside or not in the same country as the deposit institution's operational unit. Both institutional sectors are sub-divided into the following sub-sectors: Central banks, Credit institutions, General government and other sectors (households, sole proprietorships and corporations other than Credit institutions).

CLASSIFICATION OF THE SECTOR NON-FINANCIAL CORPORATIONS, SOLE PROPRIETORSHIPS AND FINANCIAL CORPORATIONS OTHER THAN CIs ON THE BASIS OF THE TYPE OF PRODUCTIVE ACTIVITY IN WHICH THEY ENGAGE FIGURE 5

Branches or sectors of activity



Productive activities. The Report refers to activities undertaken by sole proprietorships and by corporations other than Credit institutions, on the basis of the type of industry featured in Figure 5.

The definitions of the balance sheet and income statement items are to be found in Banco de España Circular 4/2004, as are the measurement bases. Nonetheless, the Glossary includes certain items in the light of their relevance for the analysis of financial stability.

2 Glossary

Asset securitisation: Assignment by an institution of its loans or other receivables (present or future) to a securitisation SPV which, in turn, issues fixed-income securities to be traded on an organised secondary market.

Asset spread: Difference between the average return on earning financial assets and average three-month euribor.

Asset-backed bonds: Bonds issued by securitisation special purpose vehicles (see asset securitisation).

Available-for-sale financial assets: Portfolio in the public financial statements which includes debt securities not classified as held-to-maturity investments or as other financial assets at fair value through profit or loss and the equity instruments of entities other than subsidiaries, jointly controlled entities or associates of the institution that have not been included in other financial assets at fair value through profit or loss.

Average total assets (ATA): Average of the assets in the period in which such assets give rise to flows of income.

Bancassurance: Strategy involving the joint provision of banking and insurance products and services, using the same distribution channel and/or the same customer base.

Basel I: Capital Accord reached by the Basel Committee on Banking Supervision in 1988. This established a set of recommendations (converted into requirements in a large number of countries) regarding capital, risk-weighted assets and an 8% minimum level for the solvency ratio, which sought to strengthen the solvency of the international banking system, as well as levelling the competitive playing field.

Basel II: Revision of the 1988 Capital Accord (Basel I). The basic aim was to promote a more risk-sensitive system of capital requirements, encouraging the use of internal risk measurement methods by the institutions for the purpose, while maintaining the overall level of solvency and ensuring a level playing field.

Beta: Measure of the systemic risk assumed by an institution. It is based on the CAPM model (Capital Asset Pricing Model), which considers the market to be the sole risk factor. The beta is calculated as the covariance between the returns on the share and the market, divided by the variance of the market return. In the FSR, the market index used is the DJ Stoxx 50, unless otherwise stated.

Bid-ask spread: The difference, at a given moment, between the highest bid price and the lowest ask price for a security.

Branch: Offices of the institution situated in a foreign country without independent legal status. They form an integral part of the institution, generally do not have separate accounts (except for internal purposes) and they may not take economic decisions or contract liabilities or possess assets in their own name. Branches are subject to the laws and supervision of the home country (that of the head office).

Business risk: That associated with the loss of the position an institution has in the market.

Capital requirements: 8% of risk-weighted assets, this being the minimum solvency ratio required by the supervisor.

Capitalisation: The market value of a company, calculated by multiplying the number of shares in issue by their price on the stock market.

Cash flow interest rate risk: Possibility of incurring losses because the future cash flows of a financial instrument may fluctuate because of changes in market interest rates (variable rate instruments).

Collateralised mortgage bonds: Securities that can only be issued by credit institutions, which enable these institutions to secure the participation, in whole or part, of third parties, in one or more mortgages of their portfolio, excluding those used to secure the issuance of mortgage bonds. The term of the bond cannot exceed the residual maturity of the mortgage loan nor can it pay a higher rate of interest.

Companies accounted for using the equity method: Mechanism for including those companies that, despite having a certain stake, are not included in the consolidated group, either on account of their business (insurance and non-financial firms), or because, although they are capable of being consolidated, they are associates, i.e. there is no control (holding of less than 20%). This mechanism consists of valuing the holdings according to the fraction they represent of the equity of the investee.

Contingent exposures: Transactions under which an institution guarantees the obligations of a third party (bank guarantees, documentary credit, credit derivatives sold, etc.

Corporate banking: Banking activity with – typically large – non-financial corporations.

Corporate bond spread: Measure of the perception of corporate credit risk. Difference between the interest rates on private bonds and risk-free bonds, in the same currency and with similar duration. In the FSR, US Treasury bonds are taken to be risk-free (or very low risk).

Cost of debt: See debt service.

Counterparty risk: Possibility of incurring losses in the event that the counterparty defaults on its contractual obligations. Unlike credit risk, it is not incurred with the issuer of a financial instrument, but with the counterparty of a transaction (normally a derivative) based on a primary instrument issued by a third party.

Country risk: The overall risk associated with customers resident in a specific country due to circumstances other than normal commercial risk. It arises from the existence of two different national jurisdictions and originates from the ineffectiveness of legal actions against a State for reasons of sovereignty. It is classified as: (i) sovereign risk, when the debtor is the State itself; (ii) transfer risk, which arises from the general inability of the residents of a country to meet their debts owing to a lack of foreign currency or currencies in which they are denominated, for example, owing to the imposition of restrictions on the conversion of the local currency to a strong currency or on its repatriation; and (iii) other risks arising from international financial activity, such as the political risk, which results from legal provisions that give rise to breach of

contract (expropriation, nationalisation, etc.) and that which arises from situations of war, social instability, catastrophic situations or situations of widespread insolvency.

Country risk impairment loss (credit risk allowance for country risk): Impairment loss in the period, charged to the income statement, on debt instruments not measured at fair value through profit or loss and on contingent exposures due to country risk, i.e. the risk associated with customers resident in a specific country due to circumstances other than normal commercial risk.

Cover ratio: The allowances for bad debts as a percentage of doubtful assets.

Covered bonds (cédulas hipotecarias): Debt securities that can only be issued, subject to certain restrictions, by credit institutions, and which are secured by all their mortgage loans, except those assigned to mortgage bonds and collateralised mortgage bonds.

Credit Default Swaps (CDS): Swap whereby the purchaser acquires (the seller grants) protection against possible non-payment by a third party. The amount paid for the insurance transaction is considered to be a risk premium, since it provides information on the probability of default by the third party. (See credit derivative).

Credit derivative: Contract involving an obligation to pay that depends either on the value of a debt instrument (loan or bond), or on the solvency, yield spread or credit rating of one or more specified borrowers. This payment obligation is performed either by cash settlement or through the delivery of the underlying asset or assets.

Credit institutions (CIs): Firms whose normal activity is to receive repayable funds from the public, other than credit institutions, in the form of deposits or close substitutes for deposits and use them to grant credits, for their own account, and those firms, other than the foregoing, who issue means of payment in the form of electronic money. Deposit institutions, specialised deposit institutions (SCIs) and the ICO are credit institutions. However, SCIs cannot raise deposits from the public, although they can raise close substitutes for deposits by, for example, issuing securities with a maturity of more than one month.

Credit portfolio: This is not a portfolio in which financial instruments are classified in the financial statements or under IAS; rather, it is the counterpart of the debt instruments held by the credit institution, i.e. the sum of the outstanding loans granted and the debt securities (fixed-income portfolio). The FSR uses this term as a synonym for financing extended and also debt instruments. This definition is valid for any specifically cited sector and for the economy as a whole.

Credit rating: Assessment of the credit quality of a debtor in accordance with its credit risk. A wide range of methods are available to reach this assessment.

Credit risk: Possibility of an institution incurring financial losses in the event of a debtor defaulting, in form and/or time, on its obligations as established in the agreement of the financial instrument. It may be presented as insolvency risk or country risk.

Currency risk: Possibility of incurring losses owing to adverse movements in the exchange rate of the currency in which the exposure is denominated.

Customer spread: Difference between the average return on the non-interbank euro-denominated credit portfolio and non-interbank financing received in euro.

Debt: The outstanding balance, at a specific time, of loans and deposits received and debt securities issued.

Debt burden arising from interest: Accrued interest as a percentage of gross disposable income in the period considered.

Debt burden: The sum of accrued interest and, if applicable, the principal of the debt repaid as a percentage of gross disposable income in the period considered.

Debt instruments: See debt.

Debt ratio: The debt of a sector as a percentage of its total assets (financial and real).

Debt service: Interest accrued and, where applicable, principal of the debt repaid during the period considered.

Deposit institutions: Subgroup of credit institutions consisting basically of commercial banks, savings banks and credit co-operatives. The only ones with the capacity to raise deposits from the public.

Doubtful assets: Debit balance sheet balances that are considered unlikely to be fully or partially repaid on the contractually agreed terms, either due to customer arrears or for other reasons (if the institution has reasonable doubts regarding their recovery).

Doubtful assets ratio: Doubtful assets as a percentage of financing extended.

Earning financial assets: Financial assets excluding accrual accounts and other financial assets, i.e. those to which it is possible to assign an explicit financial return.

Efficiency ratio: Operating expenses as a percentage of gross income; i.e. the percentage of gross income absorbed by operating expenses. A higher value of the ratio corresponds to lower efficiency.

Exchange rate effect: Reduction (increase) in the value of balance sheet or income statement items owing to depreciation (appreciation) with respect to the euro (presentation currency) of the currencies of the countries in which such items are located or generated (functional currency), without the activity, profitability or costs abroad in local currency necessarily having fallen (increased).

Expected losses: Anticipated losses, i.e. those that on average will arise on a portfolio. Calculated as the average value of the loss distribution, whether or not they have been detected.

Exposure: Amount of balance sheet assets and contingent liabilities that may be subject to risk.

Fair value interest rate risk: Possibility of incurring losses on account of changes in market interest rates (fixed rate instruments).

Financial assets and liabilities: Cash, loans, debt securities, equities, derivatives, insurance contracts linked to pensions, accrual accounts and other financial assets / liabilities. However, references in the FSR to financial assets generally refer to earning financial assets.

Financial assets / liabilities held for trading: Portfolio in the public financial statements that can be on either the assets side or the liabilities side. Those on the assets side comprise financial assets that are originated or acquired with the purpose of selling them in the near term, that are part of a portfolio of identified financial instruments managed together for short-term profit taking, or that are derivatives not designated as hedging instruments. Those on the liabilities side comprise financial liabilities that have been issued with an intention to repurchase them in the near term, that are short positions, that form part of a portfolio of identified financial instruments managed together for short-term profit taking, or that are derivatives not designated as hedging instruments. Financial assets / liabilities held for trading form part of the portfolio of financial assets or liabilities at fair value through profit or loss.

Financial conglomerates: Groups of financial institutions that cannot be consolidated owing to their nature, i.e. those made up of: 1) credit institutions and their groups and by insurance companies and their groups and, 2) those made up of insurance companies and their groups and securities-dealer companies and securities agencies.

Financing extended: See credit portfolio.

Foreign exchange risk: Possibility of incurring losses owing to adverse movements in the currency in which the exposure is denominated

Gains or losses on financial instruments: Includes: 1) the valuation adjustments of financial instruments recorded in the income statement, except the interest accrued as a result of application of the effective interest rate method and allowances, and 2) the gains or losses obtained from the sale and purchase of financial instruments except those relating to investments in group entities, jointly controlled entities and associates, and to securities classified as held-to-maturity investments. The gains or losses on financial instruments are allocated to the portfolio containing the financial instruments on which such gains or losses arise, i.e: 1) to held for trading and other instruments at fair value through profit or loss due to changes in fair value; 2) to available-for-sale financial assets and loans and receivables due to sale and purchase and 3) to other, including hedging derivatives.

General impairment losses (allowances for insolvency risk attributable to the customer): Impairment loss in the period considered, charged to the income statement and calculated by applying to the credit exposures (debt instruments not measured at fair value through profit or loss and contingent exposures, classified as standard risk) certain parameters based on the outstanding balance and the changes during the period in the various standard risk classes and in the specific impairment losses.

Goodwill: The amount of the payment made, as a consequence of a business combination, in anticipation of future economic benefits from intangible assets that cannot be individually identified and separately recognised.

Gross disposable income: Income available to the various sectors for final consumption (households and general government) and gross saving (all sectors)

Gross income: Result of adding to net interest income the share of profit or loss of entities accounted for using the equity method, net commissions, gains or losses on financial instruments, and exchange differences.

Gross operating profit of non-financial corporations: Gross value added less staff costs. It may be considered roughly equivalent to the gross operating surplus of the National Accounts and, with the necessary caveats, to the net operating income of credit institutions.

Gross value added at market prices (non-financial firm): difference between the value of its output and its inputs. Also, sales plus the changes in stocks of finished products less the cost of sales (operating expenses other than staff costs) plus the change in stocks of raw materials and work in progress.

Held-to-maturity investments: Portfolio in the public financial statements that includes debt securities with fixed maturity and fixed or determinable cash flows for which the institution has, from inception and at any subsequent date, both the positive intention and the demonstrated financial ability to hold to maturity.

Historical volatility: Annualised standard deviation of the market prices of the underlying for the period analysed. It approximates the market's perception of risk.

Impairment losses: Flow during the period, charged to the income statement, whose purpose is to correct the valuation of individual assets, or of specific groups of assets, or to anticipate specific payments or contingent charges (specific allowances), or to provide for losses that have already been incurred but have yet to be allocated to specific transactions (general allowances).

Implied volatility: Using a particular option valuation model, in which all the parameters are considered given except the underlying price of the asset in question and its historical volatility, the implied volatility is obtained, at a given moment, by introducing the market price as the underlying price of the asset. It gives an indication of the market's perception of risk.

Insolvency risk: Possibility in the normal course of business (normal commercial risk), of incurring losses as a consequence of a debtor defaulting on its payment obligations.

Interest-bearing liabilities: Those liabilities (deposits and fixed-income securities) that have an explicit financial cost associated with them.

Yield curve: At a given moment, it shows the level of effective interest rates at different terms for a risk-free asset.

Internal ratings based approach (IRB approach): Basel II encourages the institutions themselves to determine their own capital requirements, solely (advanced IRB) or partially (foundation IRB) using their own methods, according to the risk incurred.

Investment banking: Banking activity in the primary and secondary securities markets (underwriting and placement of issues, securities trading, financial advice to companies, etc.)

Kernel estimator: Non-parametric estimation of the density function, which provides a continuous and smoothed graphic representation of such function.

Large exposures: From a regulatory standpoint, large exposures are those vis-à-vis a single person or economic group, where the sum of the amount of the credit and trading-book risk exceeds 10% of the regulatory capital of the banking group. Since, on account of the high degree of exposure to one borrower, such exposures can jeopardise the solvency of an institu-

tion, in the event that the customer concerned is in difficulty, there are individual and overall limits to the large exposures that institutions can assume.

Large firms: According to the Basel Committee on Banking Supervision, in its proposed new capital accord, a large firm has annual sales of more than €50 million.

Liability spread: Spread between average three-month euribor and the average cost of interest-bearing liabilities.

Liquidity risk: Includes asset and liability liquidity risk, although in the FSR asset liquidity risk is referred to, i.e. agents' inability to dispose of their financial assets rapidly without significantly affecting market prices.

Loans and receivables: Portfolio in the public financial statements that includes financial assets that are not quoted in an active market, that do not have to be measured at fair value and that have fixed or determinable cash flows in which the holder will recover all of its initial investment, other than losses because of credit impairment. In the FSR this term is used as a synonym of credit or lending, although certain credit or lending in the public financial statements may be included in financial assets held for trading or in non-current assets held for sale.

Losses incurred: Losses that have actually arisen on an institution's portfolio.

Market index: Constructed by taking the average of a fixed but adjustable set of firms listed on a specific stock market or on various markets. Its movement is a good approximation to the movement of the stock market concerned.

Market risk: Possibility of incurring losses owing to holding financial instruments whose value may be affected by changes in market conditions. Three types of risk are included: currency risk, fair value interest rate risk and price risk, as a consequence of adverse movements in interest rates, in exchange rates and in the market prices of assets. Sometimes fair value interest rate risk, currency risk and price risk are mentioned directly, and other times market risk is called price risk.

Mixed groups: Those that include consolidated groups of credit institutions and of insurance companies. In Spain, the Banco de España or the Directorate General of Insurance and Pension Funds are responsible for their supervision, depending on the importance of their constituent institutions.

Mortgage bonds (bonos hipotecarios): Fixed-income securities specially secured by the mortgage loans assigned to them in their issue deed, which can only be issued, subject to certain restrictions, by credit institutions.

Net debit/credit balance: Difference between the financing extended (asset) and received (liability). For credit institutions, when this difference is positive the net balance is a debit one and when it is negative, a credit one.

Net interest income: Financial revenue less financial costs (sum of net interest and the return on equity instruments).

Net operating income: Gross income plus other operating gains or losses less operating expenses.

Net wealth: See net worth

Net worth: Assets less liabilities. Also called equity.

Non-voting equity units: Securities that can be issued, subject to certain restrictions, by savings banks to strengthen their capital. Their remuneration depends on the profits obtained by the institution, subject to certain limits. In the event that the institution is wound up their holders rank for payment behind the ordinary creditors, holders of subordinated debt and holders of preference shares.

Offshore centres: Territories that grant a preferential tax treatment to companies based in them.

Operational risk: Possibility of incurring losses as a consequence of inadequate internal procedures, staff or systems, or as a consequence of external events.

Own funds attributed to the group: Sum of the capital or endowment fund, share premium, accumulated reserves, retained earnings, reserves of entities accounted for using the equity method, other equity instruments, non-voting equity units and associated funds of savings banks, profit or loss attributed to the group, valuation adjustments, less dividends and remuneration and treasury shares. The average level, obtained in a similar way to ATA, is used as the denominator in the calculation of ROE. A restricted definition, excluding valuation adjustments, is sometimes used in the FSR, with the appropriate indication in each instance.

Pay-out ratio: Dividend as a percentage of profit. It indicates the proportion of earnings that a firm distributes to its shareholders in the form of dividends. In the FSR this concept is extended to include, in the case of savings banks, a numerator consisting of the annual transfer to the welfare fund and, in the case of consolidated groups, a denominator consisting of the net profit or loss attributed to the group.

PER (Price Earnings Ratio): Listed price of the shares of a particular company as a percentage of the earnings obtained thereby during a specified period (year, business cycle, etc.).

Permanent holdings portfolio: Holdings in subsidiaries, jointly controlled entities and associates intended to serve in a lasting way the activities of the institution or group to which it belongs.

Preference shares: Securities issued by credit institutions that, in certain circumstances, form part of their tier 1 capital. Their remuneration is fixed and periodic, but may be nil if the bank or its group suffer losses, in which case, normally, it is not cumulative (i.e. when no remuneration is paid one year it cannot be recovered in future). They are normally issued without a redemption term but the bank may redeem them, with the prior permission of the Banco de España, after five years.

Price risk: Possibility of incurring losses owing to adverse movements in asset prices, either on account of factors specific to the instrument itself or factors affecting all instruments traded on the market.

Primary securities market: Market on which securities are issued and redeemed.

Real assets: Non-financial assets, which include tangible assets and intangible assets.

Regulatory capital: That allowed by the regulator for the purposes of calculating the solvency ratio. Tier 1 and tier 2 capital are distinguished, on the basis of their ability to absorb losses. Spanish regulations define regulatory capital more strictly than Basel I, especially as regards tier 2 capital.

Retail banking: Banking activity with small and medium-sized businesses and households.

Return on assets (ROA): Net income (after taxes) attributed to the group as a percentage of average total assets.

Return on equity (ROE): Net income (after taxes) attributed to the group as a percentage of the average own funds attributed to the group.

Risk exposure: Product of the exposed amount and the PD assigned to such amount. The effect of loss given default (LGD) is not included.

Risk mitigation: Elements incorporated into a transaction, in the form of security interests, guarantees or credit derivatives, that help to reduce its associated risk.

Risk premium: The return required from a security in excess of that on a safe asset to compensate for the higher risk of the former relative to the latter.

Risk profile of assets: Assets weighted by risk with respect to total assets.

Risk profile of the credit portfolio: Calculated by multiplying the parameter α (alfa) of the method for estimating the general allowance or provision assigned to each of the six categories of risk by the exposure contained therein. The six categories are: *Negligible risk,* which includes, among others, exposures to EU general governments or exposures guaranteed by the latter, and interbank financing extended by the institution; *Low-risk,* which includes loans secured by mortgages on completed housing when the outstanding risk is less than 80% of the appraisal value of the housing and transactions in which the borrower is an A- or higher rated firm; *Medium/low-risk,* which includes leasing transactions not included in other risk categories and those risks secured by some security interest other than those mentioned in the preceding two categories; *Medium-risk,* which includes risks vis-à-vis residents in Spain not included in other risk categories; *Medium/high-risk,* which includes loans to individuals for the purchase of durable goods and current goods and services; *High risk,* which includes credit card balances and the current- and credit-account overdrafts of borrowers not included in the risk-free category.

Risk profile (financial assets abroad): see risk exposure.

Risk-weighted assets: The balance-sheet assets and contingent liabilities of an institution multiplied by the relevant weights, according to the instrument and the counterpart sector (Basel I). The weights attempt to reflect the credit, foreign exchange and market risk associated with each exposure.

Rollover risk or liability liquidity risk: Part of liquidity risk, although in the FSR this term refers to the possibility of losses arising from the difficulty the institution has finding funds to fulfil its commitments in relation to financial instruments, i.e. from the need to resort to the market given the lack of coincidence between the maturity of the instrument that provides the financing and the time horizon for which it is required.

Secondary securities market: Market on which securities issued on primary markets are traded.

Senior debt: Debt which, in the event of liquidation of a company, ranks for repayment before other debt.

Solvency coefficient: Regulatory capital as a percentage of risk-weighted assets, which according to current law (CBE 5/1993) shall be at least 8%.

Sovereign spread: Measure of the market's perceptions of the probability of non-payment of the government debt of a particular country. It is the difference between the return on a bond representative of the debt issued by a country and that on a bond of a country with minimal credit risk, denominated in the same currency and with a similar duration.

Spanish deposit institutions: Savings banks, co-operatives and those commercial banks that are controlled by Spaniards and have their head office or parent company in Spain.

Special purpose vehicles (SPVs): Used by deposit institutions for various purposes (e.g. securities issuance), normally, though not always, domiciled in offshore centres and, in Spanish accounting regulations, included in banks' consolidated balance sheets.

Specialised credit institutions: Financial institutions that are not permitted to raise deposits from the public, although they can raise close substitutes for deposits by, for example, issuing securities with a maturity of more than one month or borrowing on the interbank market.

Specific impairment losses (specific allowances for insolvency risk attributable to the customer): Impairment loss in the period considered, charged to income statement, arising from customer insolvency risk. The exposures that should be provisioned, with the application of specific minimum percentages, with certain exceptions are: assets classified as doubtful (due to customer arrears or for reasons other than customer arrears), substandard assets, doubtful contingent exposures and commitments (except for guarantees and other indemnities given) classified as doubtful for reasons other than customer arrears, and guarantees and other indemnities given classified as doubtful both due to customer arrears and for reasons other than customer arrears.

Standardised approach: Regulatory approach to risk measurement and capital requirements that is analogous to the current Basel I, but more sensitive to risk as it allows external ratings to be used as a measure of risk that affects the weights applied to the counterparty.

Structural position in foreign currency: Unhedged investment assets in foreign currency financed in euro (investments in property for own use, significant holdings of a permanent nature and, in the individual balance sheet for business in Spain, endowments to branches abroad), that are converted at the exchange rate of the date of their purchase (historical exchange rate).

Subordinated debt: Debt which, in the event of liquidation, ranks for repayment behind other debt, only preceding shares and, where applicable, non-voting equity units and preference shares.

Subsidiaries: Independent legal persons established in accordance with the laws of the country in which they reside that are controlled by their parent company. In general, in the FSR this term refers to subsidiaries in consolidated groups located abroad.

Syndicated loans: Loans for which a temporary association of financial institutions is created to share the burden of the loan among them.

Tier 1 capital: Basically made up of capital, disclosed reserves, preference shares and non-voting equity units, less goodwill.

Tier 1 ratio: More restrictive measure than the solvency ratio, since the numerator consists of tier 1 capital only. It must be at least 4%.

Tier 2 capital: Basically made up of subordinated debt, although certain limits apply.

Total lending: See credit portfolio.

Total spread or return on intermediation: Difference between the average return on earning financial assets and the average cost of interest-bearing financial liabilities. The sum of the institution's asset and liability spreads.

Treasury or trading activity: Operations carried out for profit on the wholesale financial markets by a special unit of the institution, involving the management of risk positions, speculation, within the limits set by the institution, and/or covering its borrowing requirements and hedging its risks. These operations also provide services to customers.

Uncommitted assets or solvency margin of insurance companies: equivalent to the own funds of credit institutions.

Unexpected losses: Unanticipated losses on a portfolio. Calculated as the loss associated with a sufficiently high confidence level of the loss distribution, less the expected loss.

Universal banking: That performed by institutions which engage in corporate, investment and retail banking activities without distinction.

Unrealised capital gains (losses): Equity valuation adjustments resulting from the profits (losses) that have arisen but are not realised in the securities portfolio recorded in available-for-sale financial assets measured at fair value through equity.

Unsectorised accounts (net): The equity of entities and other asset and liability items that are not assigned to any grouping either on the basis of residence (residents/non-residents) or on the basis of an institutional criterion (monetary financial institutions, general government and other sectors).

Value at risk (VaR): Maximum loss on a portfolio, to which a certain probability is assigned, during a specific time horizon.

Weighted average range: Weighted average bid-ask spread for listed securities.

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