FINANCIAL STABILITY REPORT

11/2009

BANCO DE ESPAÑA
Eurosistema

ISSN: 1696-2621 (print)
ISSN: 1696-3520 (online)
Depósito legal: M. 52740-2002
Printed in Spain by Artes Gráficas Coyve, S. A.

ABBREVIATIONS*

€	Euro
AIAF	Asociación de Intermediarios de Activos Financieros (Association of Securities Dealers)
ABCB	Asset-backed commercial paper
ATA	Average total assets
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BLS	Bank Lending Survey
bn	Billions
bp	Basis points
CBE	Banco de España Circular
CBSO	Banco de España Central Balance Sheet Data Office
CCR	Banco de España Central Credit Register
CDOs	Collateralised debt obligations
CDS	Credit Default Swap
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CIs	Credit institutions
CNMV	Comisión Nacional del Mercado de Valores (National Securities Market Commission)
CPSS	Basel Committee on Payment and Settlement Systems
DIs	Deposit institutions
EAD	Exposure at default
ECB	European Central Bank
EMU	Economic and Monetary Union
ESFS	European System of Financial Supervisors
ESRB	European Systemic Risk Board
EU	European Union
FASB	Financial Accounting Standards Board
FROB	Fund for the Orderly Restructuring of Banks
FSA	Financial Services Authority
FSAP	Financial System Assessment Program
FSB	Financial Stability Board
FSR	Financial Stability Report
FVCs	Financial vehicle corporations
GDI	Gross disposable income
GDP	Gross domestic product
GVA	Gross value added
GVAmp	Gross value added at market prices
IASB	International Accounting Standards Board
ICO	Instituto Oficial de Crédito (Official Credit Institute)
ID	Data obtained from individual financial statements
IFRSs	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LGD	Loss given default
LTV	Loan-to-value ratio (amount lent divided by the appraised value of the real estate used as collateral)
m	Millions
MiFID	Markets in Financial Instruments Directive
MMFs	Money market funds
NPISHs	Non-profit institutions serving households
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
SMEs	Small and medium-sized enterprises
SIVs	Structured investment vehicles
SPV	Special-purpose vehicle
TA	Total assets
TARP	Troubled Asset Relief Program
VaR	Value at risk
WTO	World Trade Organisation

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

CONTENTS

Introduction

Since the last Financial Stability Report (FSR), the extreme difficulty experienced by the international financial system and the world economy has shown signs of improving, though doubts persist over the sustainability of this recovery. In the financial arena, especially since 2009 Q2, there have been signs of improvement, manifest in stock market prices and in the easing in the main financial stress indicators. Consequently, some of the markets most affected by a widespread loss of confidence, especially in the wake of the bankruptcy of Lehman Brothers, are progressively returning to normal, as is the case with the covered bonds market. Nonetheless, other significant markets, such as that for securitisations, continued to show signs of difficulty. As from 2009 Q2 there have been positive signs of a pick-up in the world economy, albeit with doubts over the intensity of the recovery and its distribution by geographical area. In any event, it is not foreseeable that the high growth rates marking the previous boom period will be resumed in the short term.

The exceptional and temporary fiscal, monetary and financial-system-support measures adopted by the public authorities internationally have undoubtedly contributed to the improvements observed. In any event, the fragilities discussed in the previous paragraph mean particular caution is called for when considering a withdrawal of these support measures. The need to make the sustainability of the recovery compatible with the withdrawal of these extraordinary measures in the medium term is, possibly, the biggest difficulty conditioning economic policy design in the coming years.

Economic activity in Spain continues to contract and the unemployment rate is still rising, albeit at a more moderate rate than in previous quarters, and stands at a high level. As to the financial markets, some such as those for covered bonds and capital instruments have shown signs of picking up. However, there is clear dispersion, both in prices and volumes, in favour of those institutions perceived as most sound.

Accordingly, and as indicated in the previous FSR, the strong downturn in economic activity has continued influencing risks on bank balance sheets. The slowdown in credit persists, which is due to demand-side factors in the face of adverse economic circumstances and to a tightening of supply-side conditions, in response to the rise in bad debts. That said, such tightening is estimated to have moderated in recent months.

In terms of their recent growth, doubtful assets have shown signs of moderating, although they continue to rise at a high rate. This is feeding through to doubtful assets ratios, which will continue rising insofar as the downturn in real activity and employment persists. The increase in the ratios is related to the exposure to economic sectors whose behaviour is more closely linked to the business cycle. This is the case of the property development sector, which is why the present FSR offers information that allows the dimension of the problem to be put into perspective.

Nonetheless, the particular banking business strategy and risk management policy pursued by each institution translate, as is usual in all sharp slowdowns, into a high degree of heterogeneity across institutions. The growth of doubtful assets ratios depends on the economy's cyclical position, but even so the rate of increase and the level attained differ for different banks. The reason for this is that, in the long economic growth phase the Spanish economy enjoyed, banks have not followed the same strategies: not all of them have grown with the same force, and nor do they have the same degree of sectoral exposure. Even for banks similarly exposed to the same economic sectors, differences can be perceived as regards the selection of risks and their subsequent management. In sum, the outcome of the different lending policies pursued by banks is that adverse events pass through to their balance sheets and income statements in the form of effects of a different relative scale.

Funding difficulties on wholesale markets have been alleviated, especially for the soundest institutions, which have made issues without the backing of the State. Moreover, several banks, including some medium-sized ones, have issued covered bonds with yield spreads far lower than the high levels reached early in Q2, and close to those prevailing before the bankruptcy of Lehman Brothers. That shows the move towards the normalisation of this financial market segment, whose functioning had been greatly affected following the collapse of Lehman Brothers. In any event, funding difficulties persist for some Spanish banks, though these have been eased, as they have in other countries' banks, by the extraordinary interventions by the authorities (e.g. the granting of guarantees for new issues).

Income statements, albeit with differing intensity at different banks, remain subject to downward pressure. That said, the results recorded to end-June 2009 may be considered positive in the present circumstances, and comparatively better than those at many institutions in banking systems in other developed countries. The increase in the net interest margin and the moderation of operating expenses have proven to be the main favourable factors here. But they have not been able to offset the notable impact of specific provisions, which reflect the increase in bad debts, an impact only partly mitigated by the general provisions set aside. Furthermore, doubts persist over the sustainability of the net interest margin in the medium run.

The solvency ratio of Spanish deposit institutions has increased compared with the previous year, with both the total and the tier 1 ratios standing above the required minimal level for regulatory purposes. An international comparison of solvency levels places Spanish institutions in an intermediate position, although it should be borne in mind that many banks from other countries received sizeable public funds to shore up their capital.

The uncertainty posed by the macroeconomic and financial situation means that banks must take into consideration various medium-term factors to attain an appropriate level of profitability. Firstly, it is not foreseeable that banking will resume the rate of expansion seen in the past, since the deleveraging of the financial sector and of the economy as a whole cannot be considered as a temporary phenomenon. This, combined with the possibility that spreads between the return on assets and liabilities will narrow, or that they will not at least trend as favourably as they have done so far this year, will act as a notable factor of pressure on the net interest margin, the main driving force of the income statement at present. Secondly, given the current economic climate, bad debts will conceivably continue on the rise, which will entail higher specific provisions, placing further downward pressure on income and, therefore, on capital levels. In these circumstances, merely controlling operating expenses would not appear to be a sufficient management strategy, especially for banks with excess capacity in the current circumstances, which start from a less favourable position in terms of profitability and solvency, or for those for which the impact of the above-mentioned factors of pressure is more acute. Accordingly, depending on their particular circumstances, banks must address processes that enable them to streamline their operating costs and improve their management, adapting their structure and capacity to a situation consistent with the lower growth of banking and of the economy in general.

The recently created Fund for the Orderly Restructuring of Banks (FROB) should be seen in this respect as an instrument that may pave the way for the rationalisation of management and the adaptation of capacity to the new environment in which the Spanish financial system is going to operate. Given the foreseeable continuing pressure on the income statement stemming from rising doubtful assets, along with the persistent uncertainty over the profitability of a significant number of institutions' core business, the FROB will step up its activity in the coming months. What is more, this more intensive use of the FROB will be vital for helping make the inevitable restructuring of the financial system compatible with the financing of the productive economy once the current recession has been overcome.

1 Macroeconomic risks and financial markets

Improvement in the international macroeconomic and financial situation in a setting marked by the maintenance of the public-sector support measures…

… but an improvement not free from risks.

Since the publication of the last Financial Stability Report the international financial situation has improved, with a resumption of capital flows towards higher-risk assets (reflected in share price rises and reductions in lending spreads) and a decline in volatility. In parallel, a recovery has been observed in confidence in the international banking system, which posted results generally better than anticipated. These developments arose in a setting marked by favourable macroeconomic news and by the continuity and deepening of the fiscal and monetary stimulus measures applied since the onset of the crisis. But this improvement in the international macroeconomic and financial situation is not free from risks and doubts concerning its sustainability. Hence, although the risk of the financial system collapsing has diminished, there are still major market segments whose dynamism is only sustained by the support of public-sector programmes. The economic recovery is unfolding unevenly across the different geographical areas, and is closely linked to economic policy stimuli and to the positive momentum of the stockbuilding cycle. Moreover, the pace of recovery remains slow, some vulnerabilities persist in certain financial market segments, and households in many economies remain immersed in a process of deleveraging and the re-building of their saving rates.

This normalisation has provided for a recovery in confidence in the banking sector and for less resort to certain financial support programmes, especially in the United States.

The ongoing normalisation of and recovery in confidence in the financial sector has been notable in the United States, the epicentre of the financial crisis, as financial institutions are reducing their resort to several public support programmes, such as the issuance of guaranteed debt and the liquidity support facilities of the Federal Reserve. One factor that may have contributed to this has been the performance and subsequent publication by the US authorities of the results of the stress tests on the main banks. This exercise lessened the uncertainty hanging over these banks and, probably, was instrumental in the recovery of private investment in the capital of the main US banks, whereby many of them have managed to repay the public aid received under the TARP programme.

Across-the-board improvement in money and credit markets...

… with an increase in debt issues.

There was also an improvement on money markets, with interbank/OIS spreads standing below the level observed before the bankruptcy of Lehman Brothers (Chart 1.1 A). The recovery was also seen in the credit markets, meaning that corporate lending spreads narrowed substantially, although in the case of companies with a worse credit rating, spreads were still at a far higher level than their historical average (Chart 1.1 B). The recovery in confidence prompted an increase in debt issues by financial and non-financial corporations, although in the case of the former, such issues were greatly influenced by the measures enacted by the economic authorities, through programmes offering public backing to issues and others purchasing assets, such as, for instance, the Eurosystem's acquisition of guaranteed bonds (Box 2.3).

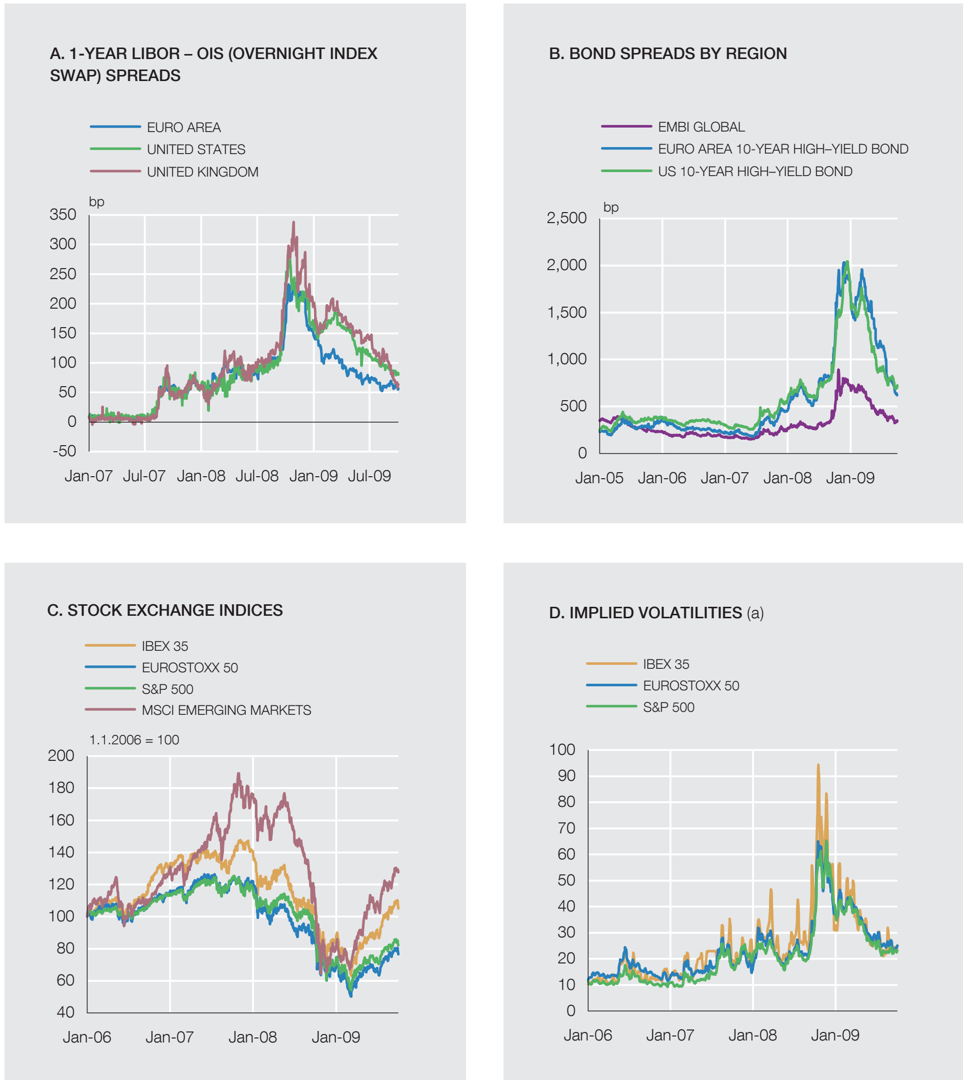
Stock markets also showed an across-the-board improvement.

The pick-up in stock market indices seen since late March continued, in the developed and emerging countries alike (Chart 1.1 C), and was accompanied by a significant reduction in volatility (Chart 1.1 D). During this period, however, corrections were also observed in certain equity markets, such as in those in China, which had accumulated far higher than average gains. Bank share prices generally rose to a greater extent than those of the other sectors, boosted by the recovery in confidence and by the reporting, especially in the case of US banks, of better-than-expected results for the first half of the year.

On the government debt markets, the upward course

On government debt markets, risk premia on credit derivatives markets and interest rates on long-term government debt have moved on a slightly falling trend in recent months, in contrast

MARKETS CHART 1.1



SOURCE: Datastream.

a. Five-day moving averages.

of long-term yields was interrupted.

to the increases observed from the beginning of the year. These developments came about despite the fact that public finances continue to worsen in several countries, and in spite of the brighter outlook for economic activity and the incipient signs of recovery. The recent course of long-term interest rates would suggest that the path of recovery discounted by the markets may be less vigorous than that seen in previous episodes.

Economic activity improved and even grew in some areas.

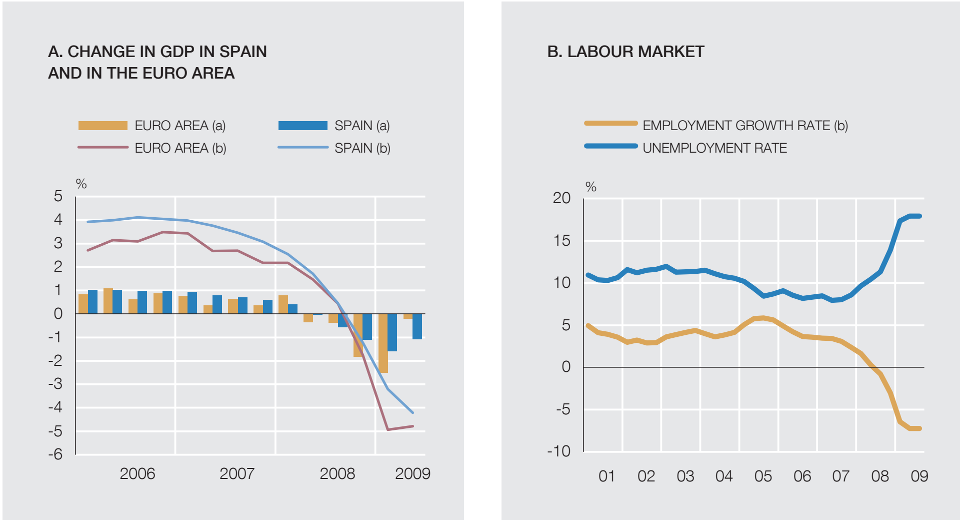
During 2009 Q2 there was a clear turning point in global economic activity, largely associated with the strong impulse provided by macroeconomic policies and with the stockbuilding cycle. After two consecutive quarters in which world GDP contracted at a rate of around 1.4% on the preceding quarter, positive growth of 0.6% was observed in 2009 Q2. This rise in Q2 was essentially due to the strong recovery in economic activity in Asia, especially in China, while the main developed economies continued shrinking, albeit at much more moderate rates.

Activity in the euro area contracted in 2009 Q2, but did so very moderately.

Following the marked fall-off in economic activity in the euro area in the last three months of 2008 and the first three months of the current year, a slight contraction was recorded in 2009 Q2. The quarter-on-quarter growth rate of euro area GDP in this period was –0.2%, compared

MACROECONOMIC DEVELOPMENTS

CHART 1.2



SOURCES: INE, Eurostat and Banco de España.

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

The macroeconomic projections have been revised slightly upwards.

with –2.5% in Q1 (Chart 1.2.A). As discussed, this lower rate of decline in output has coincided with the emergence of some signs of normalisation on financial markets and with an improvement in the confidence indicators. Last September the ECB revised its macroeconomic projections for this year and 2010 slightly downwards, placing euro area GDP in real terms at between –3.8% and –4.4% in 2009, and between 0.9% and –0.5% in 2010. The uncertainty surrounding these projections remains exceptionally high.

The data for Q3 suggest that the expansion in activity may be expected to spread across geographical areas.

The improvement in the indicators of economic activity at the international level in Q3 suggests that the macroeconomic expansion is spreading across geographical areas, auguring growth at positive rates in many economies. Growth projections for 2009 and 2010 have been revised upwards more or less across the board.

In Spain, economic activity contracted once again, albeit at a more moderate rate than in the previous quarter…

In Spain, the pace of the contraction in economic activity also eased off in 2009 Q2. In quarter-on-quarter terms, GDP fell by 1.1%, following the 1.6% decline recorded three months earlier. The year-on-year rate, which is subject to greater inertia, stood at –4.2%, 1 pp below the figure for the previous quarter (Chart 1.2 A). At the root of this decrease was national demand, the reduction in which (–6.9% year-on-year) was partly offset by the behaviour of net external demand, which contributed 3.1 pp to GDP growth, as a result of a reduction in imports (22.3%) that was greater than that in exports (15.7%).

… and the decline in employment held at around the same rate as in June.

There was some slowing in the rate of job destruction in Q2, with employment falling by 7.3% year-on-year on EPA (Labour Force Survey) figures. This decline and the increase in the labour force raised the unemployment rate by 0.6 pp in relation to March (to 17.9%, Chart 1.2.B). The latest EPA data suggest that during the summer months the year-on-year rate of decline in employment held at around the same figure as in June.

Interest rates on credit fell, and banks moderated the tightening of lending standards.

The interest rates applied by banks to households and firms in lending transactions continued to decline during the first half of 2009, albeit to a lesser extent than interbank yields. According to the Bank Lending Survey (BLS), the increase in margins is expected to have affected higher-risk loans to a greater extent. During the first half of 2009, and again on BLS figures, it is estimated that banks continued to tighten lending standards, albeit to a lesser extent than in the preceding months, following the strong tightening observed in 2008. In line with this trend, banks indicated that during Q3 they applied similar lending standards to those of the previous quarter (they were only slightly more restrictive in lending to households and firms for purposes other than house purchase). The demand for bank financing perceived by the banks reporting to the survey is estimated to have continued falling in recent months, but increasingly at a lesser pace.[1]

The interest burden on households and firms has fallen and their debt ratios have stabilised, but the ratio of household net wealth to household gross disposable income has declined once more.

During the first half of 2009, the slowdown in lending to the non-financial private sector continued, taking the seasonally adjusted quarter-on-quarter rate into negative territory. As a result of this and of the course of income, household and corporate debt ratios held stable during Q2 while the reduction in financing costs prompted a decline in the aggregate interest burden on both sectors. Household net wealth continued declining relative to gross disposable income during the same period.

The economic recession in Spain is raising the proportion of agents facing a high degree of financial pressure.

In sum, although more moderately than in previous months, recession in the Spanish economy extended into 2009 Q2 and unemployment rose. As a result, the proportion of agents under a high degree of financial pressure has continued to increase, the reflection of which has been a further rise in doubtful assets ratios.

1. For further details see J. Martínez Pagés (2009), "Encuesta sobre Préstamos Bancarios en España: octubre de 2009", *Boletín Económico,* October, Banco de España.

2.1 Deposit institutions

2.1.1 BANKING RISKS

The extremely difficult situation in the financial system and the world economy eased in 2009, although the situation continues to be difficult for financial institutions. There are market segments which are still closed…

Financial institutions face a situation which continues to be very difficult, first because of the weakened credit quality of their balance sheets, and second because the improvement in the financial markets does not mean that the difficulties in obtaining funding have disappeared. Indeed, some markets which were of fundamental importance before the summer of 2007, such as the securitisation market, continue to be closed. The recovery of the financial markets does not mean, moreover, that all institutions have the same access to them, since this depends on each institution's financial position. Thus, for example, the interbank market is only open to large, highly solvent institutions. In any event, the funding needs of deposit institutions from Spain and other countries have been alleviated by the measures taken by the ECB and by governments, which in Spain took the form of the provision of guarantees for debt issuance and the creation of a fund for the acquisition of high-quality assets. In addition, Spanish institutions reacted by stepping up their efforts to attract traditional deposits, a response facilitated by their retail banking model.

… and the management of doubtful assets is fundamental, especially for institutions which have pursued riskier lending policies,…

The weakness of the real economy is putting downward pressure on the credit quality of financial institutions' balance sheets. For Spanish deposit institutions the pressure on doubtful assets is still significant and their judicious management is crucial, especially for institutions which have been more strongly impacted as a result of riskier asset policies in the past.

… or which are less resilient.

The different responses adopted by institutions in their risk management and the differences in their profitability, provisions and solvency mean that the impact of this more adverse situation will not be uniform across institutions. The newly created Fund for the Orderly Restructuring of Banks (FROB) will help to smooth the process of adjustment, since it will act whenever any particular institution finds itself in difficulties, ensuring the minimum cost for taxpayers (Box 2.1). In any event, institutions have to properly assess their present and future financial position and, if necessary, undertake resizing to adjust to the new reality in which the sector has to operate.

The consolidated assets of Spanish institutions continue to grow at a moderate pace…

The consolidated *assets* of Spanish deposit institutions grew by 10.4% in June 2009 (Table 2.1). This increase was further boosted by the acquisitions of foreign institutions made in recent months, mainly by a large Spanish institution. Excluding this institution from the analysis, the increase in total consolidated assets was more moderate, showing growth of 5.10% (9.7% in June 2008). Also, the total assets of business in Spain grew by 5.5% in June 2009 (9.9% in the same period of 2008). The growth rate of total assets varied from one institution to another. The heterogeneity of institutions is also apparent from an analysis of the distribution of assets by corporate group. Thus consolidated assets are distributed unevenly among institutions: the five largest account for 59.6% of total assets, while the next twenty represent 24.1% and the remainder 16.3%.

… which is explained basically by the slowdown in lending.

The moderation in the growth of bank balance sheets, noted in previous FSRs, is largely explained by the behaviour of financing to the private sector (credit and fixed income) and, in particular, by the deceleration of credit. The more moderate growth of lending is consistent with the weaknesses still persisting in the real economy due to lower demand and to the greater caution of institutions in granting loans amidst rising bad debts.

Doubtful assets continue to grow sharply, although the

The economic slump largely explains the increase in doubtful assets, which continues apace (170.6% in June 2009), although more slowly than in December 2008 (year-on-year increase *rate is moderating, a trend which is reflected in the doubtful loans ratio.*

of 238.8%). The moderation in the growth rate of doubtful assets, favoured by the lower interest rates, did not prevent the doubtful assets ratio from continuing to rise (3.3% in June 2009, 1.3% a year earlier and 0.7% in June 2007). The lower growth of doubtful assets is apparent also in July and August, as discussed below in greater detail. In any event, in a macroeconomic setting which will not recover fully for some time yet, doubtful assets will continue to rise in the coming months.

The funds obtained from the Eurosystem continue to have little weight in institutions' balance sheets.

Notable on the *liabilities* side was the growth in deposits from central banks. In line with events in the Eurosystem as a whole, the net loan (the funds received in liquidity providing operations minus those deposited in liquidity withdrawal operations) has been growing since the escalation of the international financial market tensions. However, the net loan from the Eurosystem to Spanish institutions is consistent with the size of the Spanish economy in the euro area. Moreover, this net loan from the Eurosystem continues to have a relatively low weight in the balance sheets of Spanish deposit institutions (1.9% in June 2009).

The balance of the "Deposits from credit institutions" heading decreased by 1.7% in June 2009 and its relative weight in bank balance sheet fell. This development, which was also seen on the assets side ("Loans and advances to credit insitutions"), reflects the persistent difficulties in interbank markets, which are only open to the large, more solvent institutions.

The improvement on the markets has allowed institutions to issue preference shares and thus strengthen their capital,…

The difficulties still persisting in international financial markets are apparent in the year-on-year fall in marketable securities (–4.8%), which nevertheless showed quarter-on-quarter increases in March and June, reflecting the improvement in financial markets. However, not all institutions have the same ability to access these markets, since it depends on their financial position. In consonance with the aforementioned signs of a certain recovery, subordinated debt, which includes preference shares, grew strongly in June 2009 (17.6%, against 1.2% in December 2008 and against 2.1% in June 2008), and this also helped to strengthen the level of Spanish institutions' own funds.

… whereas deposits, while expanding at a more moderate pace, continue to grow faster than credit.

In response to the difficulties besetting international funding markets, Spanish deposit institutions increased their capacity to raise deposits from the private sector. Despite the lower rate of increase over the last few months, the June 2009 data show that they are still growing[1] at a rate which, although slower, exceeds that of credit to the private sector.

Own funds have also grown.

Own funds grew by 11.0% in June 2009 and their relative weight in the total balance sheet remained at the levels of June 2008 (5.5%). As indicated in the last FSR, the negative amount of the valuation adjustments to equity is explained by exchange differences, the result of including the business abroad of Spanish deposit institutions in the balance sheet in a period in which the euro appreciated.

The relative weight of business abroad increased as a result of some recent acquisitions.

As a result of the aforementioned acquisitions, the relative weight of business abroad in the consolidated total assets of deposit institutions was 23.5% in June 2009 (19.9% in June 2008). The presence of Spanish institutions, through subsidiaries, initially focused on emerging Latin-American countries (exposure to eastern European countries is very low) has been diversifying towards other geographical areas, such as the United Kingdom and, to a lesser extent, the USA.

1. The growth of this variable in the consolidated balance sheet is boosted by the aforementioned acquisition of foreign institutions by a large Spanish institution. However, excluding this institution, deposits still show positive rates of change which exceed the growth rate of credit.

CONSOLIDATED BALANCE SHEET TABLE 2.1
Deposit institutions

ASSETS	JUN-09	CHANGE JUN-09/ JUN-08	RELATIVE WEIGHT JUN-08	RELATIVE WEIGHT JUN-09
	(€m)	(%)	(%)	(%)
Cash and balances with central banks	108,739	99	1.6	2.9
Loans and advances to credit institutions	224,231	-21	8.4	6.0
General government	69,269	24	1.6	1.8
Other private sectors	2,412,475	6	67.0	64.3
Debt securities	478,843	37	10.3	12.8
Other equity instruments	70,171	-24	2.7	1.9
Investments	35,860	-25	1.4	1.0
Derivatives	171,071	52	3.3	4.6
Tangible assets	44,605	22	1.1	1.2
Other (a)	135,355	58	2.5	3.6
TOTAL ASSETS	3,750,619	10	100	100
MEMORANDUM ITEMS				
Financing to private sector	2,561,029	7	70.5	68.3
Financing to general government	294,517	46	5.9	7.9
Total doubtful assets	104,226	171	1.1	2.8
Total doubtful assets ratio	3.28	198 (c)		
Provisions for bad debts and country risk	62,991	38	1.3	1.7

LIABILITIES AND EQUITY	JUN-09	CHANGE JUN-09/ JUN-08	RELATIVE WEIGHT JUN-08	RELATIVE WEIGHT JUN-09
	(€m)	(%)	(%)	(%)
Balances from central banks	156,243	136	2.0	4.2
Deposits from credit institutions	496,507	-2	14.9	13.2
General government	108,338	33	2.4	2.9
Other private sectors	1,710,693	12	44.8	45.6
Marketable debt securities	634,386	-5	19.6	16.9
Derivatives	159,047	22	3.8	4.2
Subordinated debt	103,364	18	2.6	2.8
Provisions for pensions, tax and other	36,313	11	1.0	1.0
Other (a)	133,848	31	3.0	3.2
TOTAL LIABILITIES	3,538,739	11	94.1	94.4
MEMORANDUM ITEMS				
Eurosystem net lending (b)	70,703		1.39	1.89
Minority interests	10,352	1	0.3	0.3
Valuation adjustments relating to total equity	-6,294		0.1	-0.2
Own funds	207,822	11	5.5	5.5
TOTAL EQUITY	211,880	6	5.9	5.6
TOTAL LIABILITIES AND EQUITY	3,750,619	10	100	100

MEMORANDUM ITEMS TOTAL ASSETS OF:	JUN-09	RELATIVE WEIGHT JUN-08	RELATIVE WEIGHT JUN-09
	(€m)	(%)	(%)
Five biggest banks	2,236,166	57.0	59.6
Twenty next biggest banks	902,248	25.8	24.1
Other banks	612,205	17.2	16.3

SOURCE: Banco de España.

a. The remaining assets and liabilities entries not explicitly considered, including valuation adjustments, are included in "Other".
b. Difference between funds received in liquidity providing operations and funds delivered in absorbing operations.
c. Difference calculated in bp.

THE FUND FOR THE ORDERLY RESTRUCTURING OF BANKS (FROB)

BOX 2.1

The Spanish financial system has demonstrated its strength and solvency in facing the challenges arising from the financial crisis. This is the result of several factors: among others, its practically nil exposure to toxic assets, prudent risk management and the establishment of a regulatory framework which encourages implementation of these prudent management practices. In short, Spanish institutions have adopted a more traditional banking management model, far removed from the originate to distribute model.

However, the Spanish financial system is not immune to the deepening and quickening of the financial crisis, characterised by certain endogenous factors such as developments in the property market in Spain and the cyclical position of the economy, which is now facing a significant recession. On this basis, it is appropriate to tackle the process of bank restructuring, as has occurred in the past in other economic sectors.

In principle, this process could be based solely on traditional individual crisis-resolution mechanisms with the participation of the Deposit Guarantee Funds (DGFs), which act not only in a compensatory but also in a restructuring capacity. However, the situation created by the international financial crisis has compelled financial authorities to take pre-emptive steps with the creation of this new instrument, the FROB, through the approval of Royal Decree-Law 9/2009. The ultimate aim of this strategy is to provide for an orderly restructuring process so that capacity may be tailored to the foreseeable size of the banking industry in the future.

The FROB's actions will be governed according to the following principles:

– The restructuring process must be based on the traditional crisis-resolution process in Spain.

– The FROB is a subsidiary mechanism for action.

– It must look for solutions for individual credit institutions which minimise the cost for the public.

– Widespread recapitalisation plans are avoided, by treating the problems of credit institutions individually.

– It promotes the accountability of shareholders and managers of the institutions subject to a restructuring process.

As for its *legal regime,* the FROB has been endowed initially with €9 bn, €6.75 bn were contributed by the State and €2.25 bn by the DGFs. Furthermore, it may raise borrowed funds for up to three times this figure, increasing the initial amount assigned by up to ten times from 1 January 2010 subject to authorisation from the Ministry of the Economy and Finance. The FROB is governed by a Management Committee with five representatives of the Banco de España and three representatives of the DGFs and a representative of the National Audit Office who will attend meetings with the right to speak but not to vote.

As for the FROB's actions, Royal Decree-Law 9/2009 envisages firstly *restructuring processes of institutions* which present weaknesses that may affect their viability, as follows:

– Initially, the institution affected will look for a private solution involving the strengthening of its solvency.

– In the absence of a private solution, the next stage is to adopt measures with the participation of the DGFs. Accordingly, the institution must submit an action plan to the Banco de España which may include the following courses of action: strengthening capital and solvency, participating in a merger or the full or partial transfer of its business. The FROB may extend financing to the DGFs so that they can provide the aid.

– If a solution cannot be reached through the above-mentioned channels, the FROB will take control of the institution and will be appointed as its provisional administrator. In such cases, a restructuring plan will be drawn up, the purpose of which will be the merger or takeover of the institution or the full or partial transfer of its assets and liabilities. The plan may include management and financial support measures such as the provision of guarantees, the acquisition of assets or equity securities.

Apart from the restructuring processes, the FROB may also *facilitate mergers between institutions* which are aimed at consolidating their medium-term efficiency by strengthening the capital of the resulting institution. In this case, institutions must submit a merger plan including improvements in efficiency, in rationalisation of their administration and the restructuring of their production capacity. In this case, the FROB may temporarily acquire preferential holdings which can be converted into ordinary shares, non-voting equity units or capital contributions.

One aspect creating some confusion is how swiftly the FROB must act. Aside from the fact that the prompt implementation of restructuring projects benefits the institutions affected, the financial system and the economy as a whole, it is necessary to take into account several defining elements of the FROB. Firstly, its legal structure establishes a series of priorities or steps, initially prioritising voluntary preventive operations, on the institutions' initiative, which, in turn, may contribute to minimising the use of public funds. Many developed countries took swift action. But it must not be forgotten that in all cases the impact of the financial crisis on their banks was immediate; an enormous amount of the system was deeply affected, compelling authorities to act immediately to prevent it from collapsing. Furthermore, while the action in other countries involved bail-outs of individual institutions, in Spain the emphasis is on the medium-term strengthening of profitability and solvency through integration processes (which need to be planned and implemented more carefully). Lastly, it must not be forgotten that a significant part of the Spanish system is made up of savings banks (with distinctive government and stewardship structures that will tend to draw out the process). In spite of these specific characteristics, it would evidently be appropriate to significantly speed up integration processes.

In short, the recently created FROB is an instrument which can facilitate the rationalisation of management and streamlining of capacity, tailoring them to the new environment in which the Spanish financial system will be operating. Although the pace at which the FROB acts is dictated by both its legal design and the distinctive features of a significant part of the Spanish financial system, it is highly likely that it will step up its activity in the coming months.

The expansion of Spanish institutions is, and has been in the past, effected through subsidiaries subject to local solvency and liquidity requirements.

Spanish institutions have internationalised through subsidiaries, typically acquiring pre-existing banks with extensive experience of the local markets. The business of these subsidiaries is fully compatible with the business model of the Spanish parents (traditional business in local currency), which makes for readier incorporation of improvements in the subsidiaries' management and efficiency. Moreover, the subsidiaries have to meet the local capital and liquidity requirements, which facilitates the management of the potential difficulties that may arise for these institutions.

Credit to the private sector in Spain continued to decelerate…

Credit to the resident private sector in Spain continued to decelerate, and its growth for deposit institutions was 1.1% in June 2009 (10.9% a year earlier). The most recent data available indicate that this trend persists (0.6% in July 2009, in year-on-year terms, and virtually unchanged from the previous year in August 2009).

… due to the situation of the real economy, although the growth rate varies across institutions.

The deterioration of the Spanish economy explains this behaviour of credit, which will conceivably continue as long as there are no clear signs of improvement. The impact of the business cycle on credit is explained by the lower demand, but also by supply factors associated with the stricter credit standards applied by institutions to their customers in response to the deteriorating credit quality. Although the rates of change of lending vary across institutions, the slowdown is general, as a result of the impact exerted on this variable by an economy in recession (Chart 2.1.A).

Sectoral analysis shows that the slowdown is more pronounced in construction and property development…

Sectorally speaking, the slowdown is also general, although differences are apparent (Chart 2.1.B). The quarterly data as at June 2009 show that the construction and real estate development sector slowed most sharply (–2% in June 2009, 10.3% in June 2008 and 36% in June 2007). As reiterated in various FSRs, the performance of this sector is closely tied to the business cycle. It thus showed strong growth in the past and is now undergoing a marked deceleration. For other non-financial corporations, the borrowing growth of which grew more moderately in the past (19.3% in June 2007), not only is the slowdown relatively less sharp, but their growth rate in June 2009 was 5.3%.

… and in lending to households for purposes other than house purchase.

Lending to households for purposes other than house purchase (basically consumption) underwent the second-highest slowdown, and also showed a decrease in June 2009 (–8% year-on-year). For its part, lending for house purchase also slowed notably (1.7% in June 2009).

Doubtful assets grew sharply, but less so than in previous months, a development favoured by the lower interest rates.

The *doubtful assets* of the banking sector *in Spain* continued to grow at very high rates (184% in June 2009), although less rapidly in the last few months (287% in March 2009 and 327% in December 2008). This is a development common to all sectors and also observed in terms of the year-on-year change in their volume (Chart 2.2.A). Contributing positively to this behaviour was the low level of interest rates, which partly offsets the difficulties of firms and households by relieving their financial burden. The trend towards more contained growth of doubtful assets is apparent in the July 2009 data, which show a year-on-year increase of 118%, and in the August data (98%).

The doubtful assets ratio of the resident private sector continue to rise, although less rapidly…

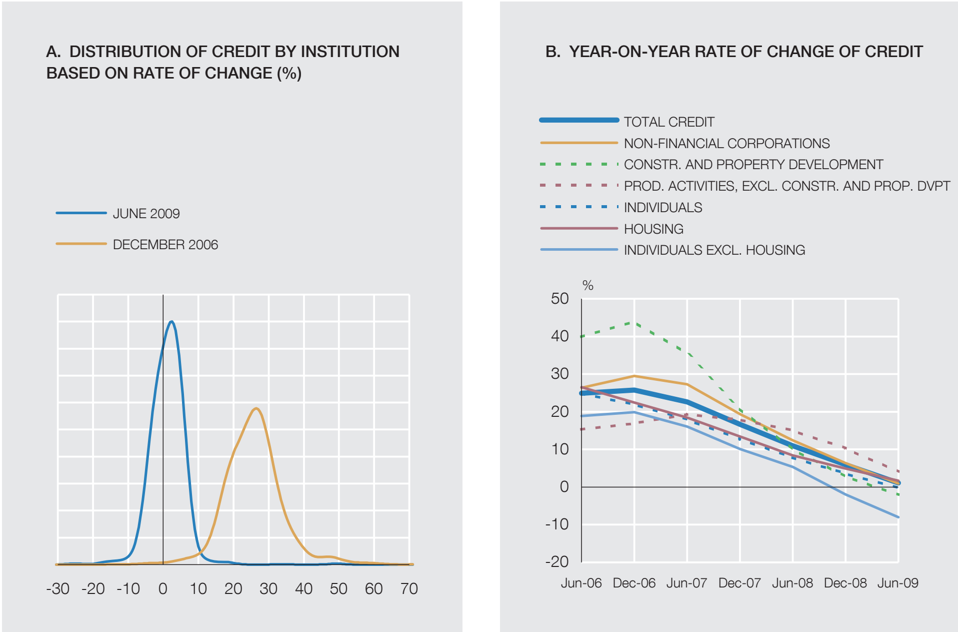
The *doubtful assets ratio* of Spanish deposit institutions has continued rising since the last FSR. The rise in the doubtful assets ratio was concentrated in the resident private sector (which accounts for 95.7% of total doubtful assets) and in June 2009 stood at 4.5% (4.6% in July 2009 and 4.9% in August 2009). However, in line with the behaviour of doubtful assets, the growth rate of the doubtful assets ratio has slowed (Chart 2.2.B).

…, but their upward movement will persist in the coming months.

The doubtful assets ratio still stands at levels below those of 1993 (when it reached 8.5%, Chart 2.2.C), although its upward movement will persist despite slower doubtful assets growth so long as the worsening of real activity and the rise in unemployment continue.

CREDIT TO RESIDENT PRIVATE SECTOR
Deposit institutions. ID

CHART 2.1



SOURCE: Banco de España.

Doubtful assets ratios are higher in lending to the sectors most exposed to the cycle, such as construction and property development…

The increase in doubtful assets largely stems from exposure to the economic sectors which have historically shown themselves to be more at risk. This is the case of construction and property development, which has a very strongly marked cyclical profile now reflected in its high doubtful assets ratio (8.2% on quarterly data for June 2009, Chart 2.2.D), significantly above that of the resident private sector (4.5% in June 2009). Other non-financial corporations, however, have a much lower doubtful assets ratio (3.3% in June 2009, Chart 2.2.D).

There is a positive relation between the level of exposure to construction and property development firms and the total doubtful assets ratio, as follows. Institutions which assumed higher exposures to this sector in the upturn now report higher total doubtful assets ratios.

… but the dispersion among institutions also reflects differences in risk selection and management.

However, as argued in past FSRs, apart from different sectoral exposures, the differing doubtful assets ratios of institutions reflect their risk selection and management capabilities. This is apparent in the high degree of dispersion of institutions' doubtful assets ratios, which nevertheless is lower than in 1993 (Chart 2.2.C). Moreover, this dispersion is observed both in general and for institutions more exposed to the construction and property development sector (Chart 2.3).

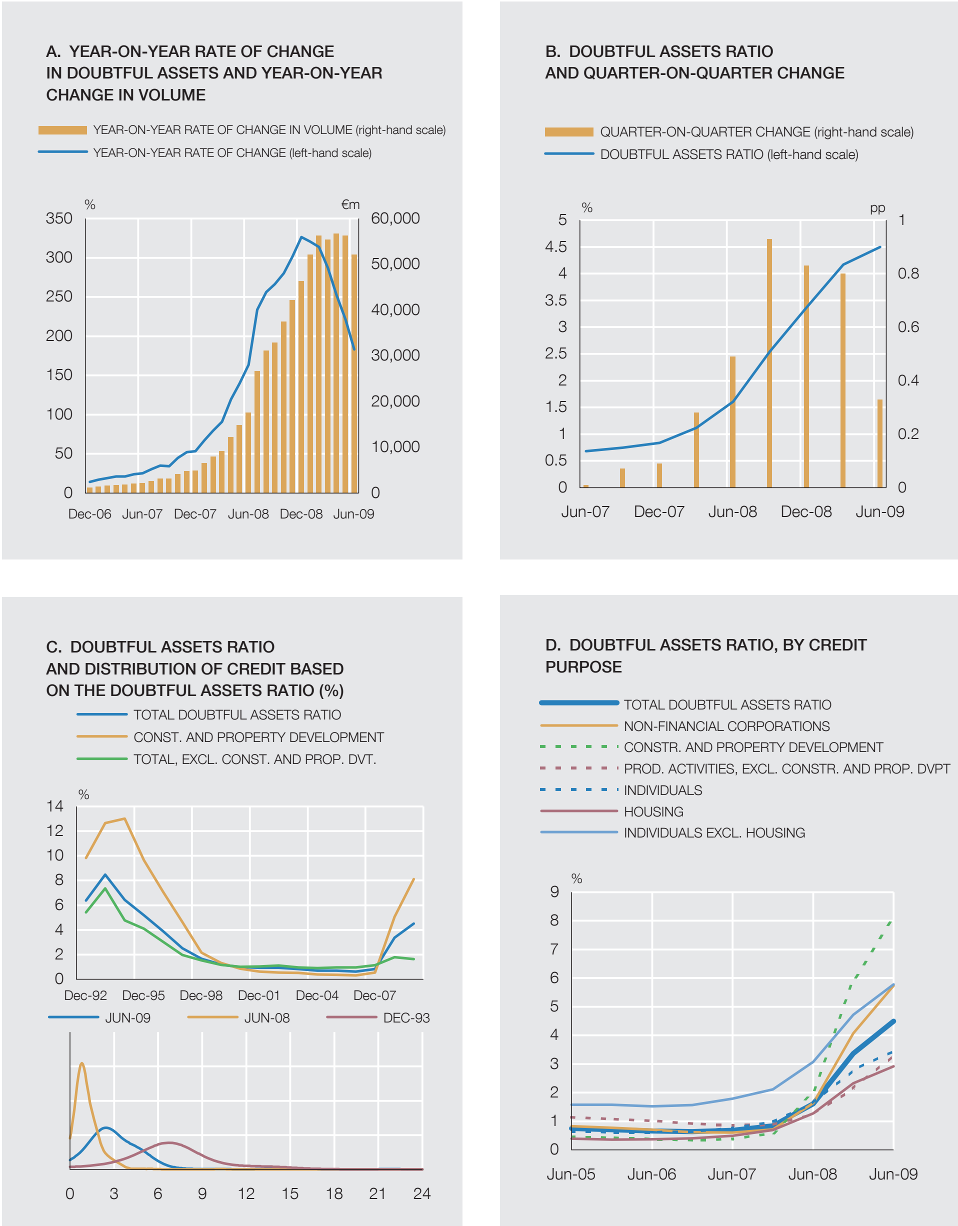
Having real collateral limits the loss in the event of default.

Collateral and, more specifically, how much of the loan it represents, limits the loss in the event of default on that loan. In Spain, in mortgage loans granted to non-financial corporations and sole proprietorships (92% of which are first mortgages), exposures with a LTV (ratio of the loan amount to the collateral value) below 80% account for 87.4% of the total risk, while the amount of exposures with a LTV above 100% is marginal[2] (Chart 2.4.A). A low volume of exposure in loans with a LTV above 80% is quite common in the Spanish mortgage market.

2. The Banco de España, through its Circular 6/2008, which introduces certain accounting changes, has increased the amount of information on the mortgage market which it requires institutions to report to it.

DOUBTFUL ASSETS OF THE RESIDENT PRIVATE SECTOR
Deposit institutions. ID

CHART 2.2



SOURCE: Banco de España.

Analysis of the exposures linked to the real estate sector calls for institution-by-institution and loan-by-loan scrutiny.

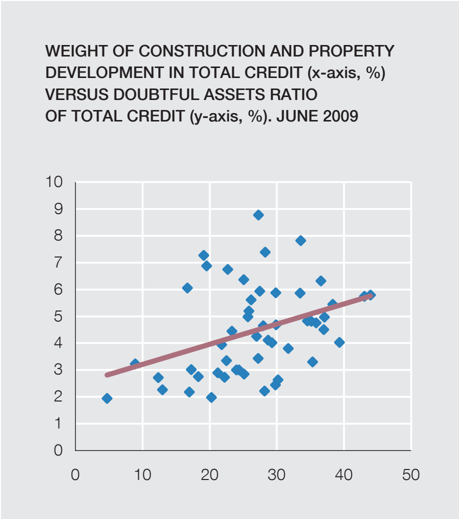
Notable among these collateralised loans for their importance in Spain are those associated with the housing development sector. When analysing this sector's impact on the financial system, it must be kept in mind that the exposure to the housing development sector consists of credit transactions which vary considerably both in loan purpose (for construction of principal residence or second home, among others) and in the collateral provided (mortgages on finished housing developments or on land, for example). A proper analysis would therefore require a detailed examination institution by institution and loan by loan.

Resilience of the Spanish credit system in the face of exposures arising from the property development sector.

Despite these reservations, some calculations can be made to put into perspective the scale of the problem. Four key parameters are used: the exposure and its nature; the probability of default on that exposure; the recovery, by realisation of the collateral, of part of that exposure (the complement, up to unity, of the loss in the event of default, or LGD); and the existence of sufficient recurring profits to withstand the losses arising on the bad debts. These parameters

SECTORAL EXPOSURE AND DOUBTFUL ASSETS RATIO BY INSTITUTION
RESIDENT PRIVATE SECTOR. Deposit institutions. ID

CHART 2.3



SOURCE: Banco de España.

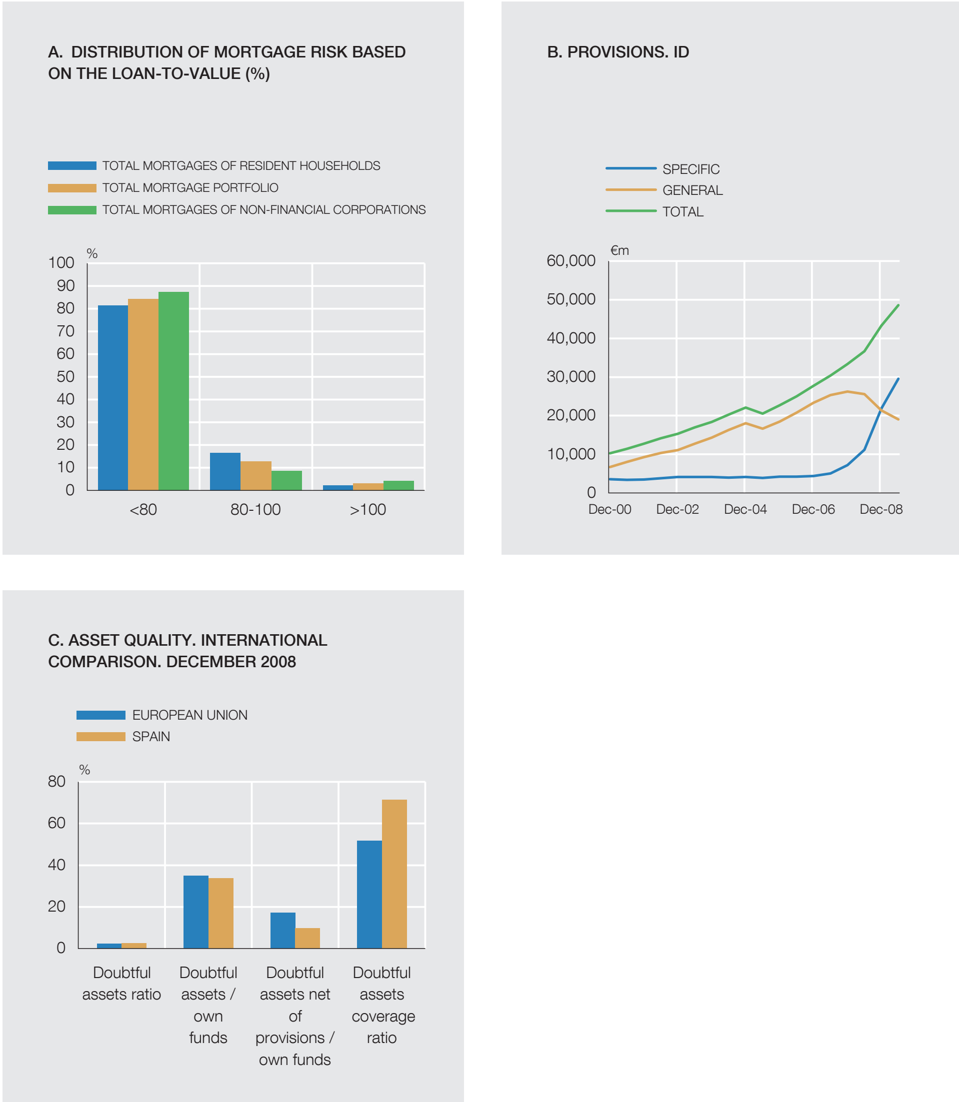
a. Outliers have been dropped from the chart. The institutions represented account for approximately 90% of total credit.

can be combined to carry out a simple but illustrative calculation of the degree of resilience of the Spanish financial system as a whole. Taking as a starting point the net operating income (roughly, profit before provisions) for 2008 and assuming a mechanical decrease of 10% in the following three years, the cumulative 2009, 2010 and 2011 net operating income would be sufficient to withstand a loss on the housing development portfolio of 40% (i.e. the sum of the net operating incomes for these three years represents 40% of the loans to the housing sector). Any loss on a credit portfolio can be broken down into two factors: the first is the probability of default by the customer (default rate), and the second is the net loss in the event of default (LGD), which depends, among other things, on the realisable value of the collateral. This breakdown shows that the system could withstand a 40% default rate (three times higher than that of 1993 for this sector) and a net loss of 100% (much higher than any reasonable estimate and than past experience). Note that what is being assessed is the ability to absorb potential future losses caused by exposures to the housing sector taking into account only the capacity to generate recurring income and disregarding the fact that loan loss provisions of €50 billion, at a consolidated level, had already been set aside as at December 2008. Evidently, these figures relating to the losses absorbable by the sector are not estimates, since they lie outside any reasonable range or known international past experience, both because of the high probabilities of default and because of the very low recovery rates associated with that percentage of default. However, they allow us to put into perspective the resilience of the Spanish credit system as a whole.

Under lending to households, that intended for consumption shows higher doubtful loans, while that for house purchase is lower, a phenomenon explained by the characteristics of this that for house purchase is

Under lending to households, that intended for consumption purposes has a higher doubtful loans ratio (5.8% in June 2009, Chart 2.2.D). This is because consumer credit is closely linked to the business cycle, and particularly to the financial position of households. Any weakening affects consumer finance more than lending for house purchase, which has the lowest doubtful assets ratio amongst the economic sectors considered (2.9% in June 2009, Chart 2.2.D). In previous FSRs it was argued that house purchase lending (36% of total credit portfolio) traditionally had a lower default rate due to the special features of the asset acquired (houses are extremely important to households) and the type of business conducted by institutions (traditional banking model). Nine of every ten mortgages granted to

MORTGAGES IN SPAIN, PROVISIONS AND INTERNATIONAL COMPARISON CHART 2.4
Deposit institutions



SOURCES: ECB and Banco de España.

lower, a phenomenon explained by the characteristics of this market in Spain. Moreover, the risk exposure concentrated at high LTV levels is low.

households are first mortgages, and of these 79.7% are to purchase their primary residence. These figures demonstrate that the asset being financed is particularly important for Spanish households, especially in a country where a high percentage of households own their own home. The consequences of the traditional business model can be appreciated in the LTVs of these loans, since 81% of mortgage exposures to households have an LTV below 80% (Chart 2.4.A).

Spanish dynamic provisions have dampened, but not delayed, the impact of bad debts on the income statement.

Spanish dynamic provisions have dampened the impact of bad debts, particularly in the initial stages of the outbreak. This does not mean that institutions delayed recognition of bad debts in results, but rather the contrary, since in the cyclical upturn, when defaults were low, the risks accumulated in balance sheets were recognised by reducing profits through the recording of provisions. Now that the downturn has arrived, this provision can be used by institutions (Chart 2.4.B).

The effect of this mechanism on coverage ratios (provisions divided by doubtful assets) is that they diminish in situations like the present (they have gone from levels higher than 200% in the upturn to slightly less than 60% in June 2009). Not only is this not a cause for concern, but it is expected, and even desirable, since under the Spanish system of dynamic provisions the funds set aside, with a charge to income, in upturns, can be used in times of difficulty.

Dynamic provisions alone cannot prevent the impact of a sharper-than-expected deterioration in the Spanish and world economies.

It cannot, however, be expected that dynamic provisioning alone will neutralise the negative impact of a downturn which at world level has turned out to be sharper than expected. This impact will be more serious for some institutions than for others, and overcoming it will require measures designed to put profitability on a sustainable path in the medium term.

The Banco de España has recently clarified its rule on provisions, which, in the absence of that clarification, could have been interpreted as meaning that the value of collateral was considered to be zero.

Recently the Banco de España has clarified its rules on provisioning,[3] particularly the calculation methods affecting credit backed by real estate collateral in the form of finished houses, offices or commercial premises, or rural properties. Thus the minimum provisioning percentages set by the Banco de España Circular for credit transactions (which depend on the number of days past-due) will be applied to the loan amount less 70% of the appraised value of the collateral, which value must be updated with the utmost prudence. The wording of the Accounting Circular could have led the reader to consider, since the provisions were set at 100% of the loan amount after two years, that the value of the collateral was zero. This was not consistent with historical experience and was scarcely justifiable in respect of the recognition of the collateral, depending on whether the LTV was above or below 80%; this inconsistency is addressed in the new clarification. In any event, the clarification of the rule basically affects a volume of risk exposure which represents not more than 14% of total mortgage lending. Moreover, the accounting rule sets minimum percentages to be applied and it is the institutions which, on the basis of their historical experience, have to calculate their loss indices, adjusting upward the minimums set by the Circular. These minimums, particularly for some types of financing such as consumer credit, may now seem low.

Credit quality is deteriorating in all European countries, the provisions set aside being higher in Spain.

Credit quality is deteriorating in all comparable European countries, which were posting doubtful assets ratios similar to those of Spain in December 2008.[4] The differences detected related to coverage, which was higher in Spain (Chart 2.4.C). The doubtful assets ratio of the large European institutions, at consolidated level and according to the information published, was around 3.8% in June 2009, while that of the large Spanish banks was 2.6%.

Despite the improvement in the financial markets, the persisting difficulties provided reason for continuing the extraordinary government support measures.

The international financial market crisis caused a widespread loss of confidence and, consequently, the closure of the main *funding* markets. The central banks responded by taking measures, in many cases non-conventional (Box 2.3), to provide liquidity to the financial system, while governments guaranteed the issues of financial institutions in order to smooth their access to the funding markets. These temporary and extraordinary measures remain in place because Spanish and international financial institutions are still finding it difficult to obtain funding.

Spanish institutions have resumed issuance of mortgage covered bonds,…

However, recent months have seen a certain recovery in the international financial markets, although some markets which were very important before the summer of 2007, such as the securitisation market, remain closed. The relative recovery of markets has enabled institutions to launch issues on markets which, until a few months ago, were not operational, although institutions' ease of access to these markets varies according to their financial position and to the expectations of financial agents in regard to them. So far this year Spanish deposit institutions have issued mortgage covered bonds (excluding securitised bonds) amounting to €19.6 billion, practically the same amount issued in the whole of 2008.

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3. In this connection, see Box 2.2. **4.** The latest available data were published in August 2009 by the ECB in "EU Banking Sector Stability". They are consolidated-level data.

ACCOUNTING REGULATIONS AND SUPERVISORY ACTION IN RELATION TO BAD DEBTS ON BALANCE SHEETS

BOX 2.2

The aim of this Box is, firstly, to recall the characteristics of the Spanish provisioning system; secondly, to review active management mechanisms for defaults and to spell out the Banco de España position on them; and thirdly, to clarify the relative significance of these operations.

Although their rate of increase has declined, bad debts will continue to rise in the coming months, and it is not possible to accurately predict how they will trend in the future. The ultimate losses associated with these bad debts largely depend on the collateral held. Many loans are granted to the real estate development sector (land, developments under way and finished housing) and their valuation is subject to uncertainty since, unlike the financial assets on the balance sheets of wholesale and investment banks (which are recorded at market value or fair value), these loans (which are recorded at amortised cost) are very heterogeneous, they have no organised secondary markets and, therefore, their valuation is very complicated. Accordingly, the traditional practice has been to opt for a progressive recognition of impairment that allows the actual loss to be recorded over time and as further evidence on prices observed in highly fragmented and dispersed markets is obtained.

Along these lines, the regulatory and supervisory criteria used in Spain, which are characterised by regulatory rigour in respect of accounting, intensive inspection and transparency, offer a clear general framework for the valuation of assets and their attendant risks. The asset valuation system, and therefore the setting aside of provisions for loan losses in Spain, is based on rules that set a timetable of specific provisions with minimum provisioning parameters. Unlike other approaches, in which the amount of provisions to set aside is decided freely by each bank and its auditor, in Spain there is an additional rule on minimums (Annex IX of the Accounting Circular) where under the mere passage of time, without the bank obtaining reimbursement of an unpaid debt, is considered sufficient evidence of the decline in the recoverable amount of the loan, which should be covered by provisions, thereby lessening profits. Given that the periods envisaged to record provisions for past-due loans are relatively short, after some time the coverage of the loss is ensured. Further, there is a requirement for provisions to cover not only past-dues but also those in which, due to other factors, it is estimated that the funds lent might not be recovered as and when contractually envisaged (doubtful exposures for subjective reasons), and those in which some less defined symptom of weakness is present, even if this is associated solely with developments in the borrower's industry (sub-standard risk). Bank inspections encourage the early identification of these situations. In sum, the Spanish provisioning system is demanding, both in booms and recessions, and is recognised as such internationally.

Finally, transparency is another key feature. This is the case in terms of both the rules to be applied, and their impact on the financial system (the rules applicable and the interpretations clarifying them can be found on the Banco de España website, doubtful assets ratios are published monthly in the Bank's Boletín Estadístico, and its Financial Stability Reports have offered highly detailed information on the Spanish financial system).

One of the key management areas at all credit institutions is the pre-emptive and palliative management of bad debts. Among the active management mechanisms for these situations are, firstly, the refinancing of customers experiencing liquidity problems, but with businesses that have the ability to pay and are solvent over the medium term; and, secondly, dation in payment and asset foreclosure, when the customer does not have the ability to pay and the bank's active management of the collateral may minimise the loss. The attitude of the Banco de España to these estimates is one of strict watchfulness since, although they are accepted management instruments in times of crisis, they should be prevented from being used to postpone recognition of the loss. Accordingly:

- When the refinancing of large-value loans is agreed, the Bank analyses the business plan to form an opinion on its viability, and it subsequently monitors the degree of compliance with the envisaged steps of the plan. On the basis of this analysis, loans are classified case by case as doubtful, sub-standard or standard, and the corresponding provisions are required depending on the terms laid down in the minimum-parameters rule and, in any event, on recoverability expectations. If retail loans are involved, provisions are also set and the policies pursued by banks are examined, analysing the terms they offer to customers to bring instalment payments into line with their economic situation. Also, deferral of recognition of default is not allowed in those refinancing agreements which, owing to the facilities granted to customers in the short term, add greater uncertainty as to how the operation will unfold in the medium term.

- In the case of dation in payment and asset foreclosure, banks have to update the appraisal value and, if this is lower than the amount of the loan net of provisions, they must provide for the difference. In addition, a provision must be made for another 10% of the value resulting from the foregoing comparison at the outset, and a further 10% one year after the foreclosure, without the asset having been disposed of. It is further required that banks should have a plan to sell the assets acquired. This plan is monitored and, as the accounting rules stipulate, if the plan is not carried out, the loan has to be recorded as doubtful and the impairment of the assets recognised.

In short, the use of these practices is part of the overall credit management process (loan approval, monitoring of the risk, recovery of problem assets), not only for Spanish institutions but also for any bank. Arrangements are in place for the oversight of these practices which, among other matters, require institutions to make write-downs from the outset.

In any event, the assets affected by these transactions (refinancing, dation in payment and asset foreclosures) account for around 2.4% of the consolidated balance sheet.

To conclude, in circumstances as complex as those currently in place, marked by an acute economic crisis and compounded in Spain by the adjustment of the real estate sector, analysis of the impact of bad debts on the Spanish banking system cannot be simplistic. On the contrary, a granular approach is needed that considers the heterogeneity of banks, the diversity of their operations and the different bad debt management policies pursued. In any event, as indicated throughout this FSR, the difficulties the Spanish banking industry faces suggest that the FROB will step up its activity in the coming months.

THE EUROSYSTEM'S COVERED BOND PURCHASE PROGRAMME

BOX 2.3

On 7 May 2009 the Governing Council of the ECB announced its decision to implement a programme to purchase euro-denominated covered bonds (which include Spanish mortgage and territorial covered bonds). Its purpose was multiple: (i) to provide for a lowering of money market forward interest rates, (ii) to ease the financing conditions for credit institutions and firms, (iii) to give credit institutions the incentive to lend, and (iv) to improve the liquidity of large segments of the private debt market, since this segment of financing was one of those most affected by the financial crisis.

The €60 bn euro-area wide programme is implemented through direct purchases by the various Eurosystem national central banks and the ECB. These purchases were made gradually between July 2009 and June 2010 in primary and secondary markets. The counterparties may be those institutions which participate in Eurosystem monetary policy operations and investment counterparties established in the euro area. Eligible assets are those covered bonds which fulfil a series of conditions regarding their eligibility, issue volume and denomination, among others.

The implementation of the programme began on 6 July 2009. At the end of August the nominal amount of covered bonds purchased by the Eurosystem was €9,482 million: €5,085 million in July (€1,867 million were purchased on the primary market and €3,218 million on the secondary market) and €4,397 million in August (only €243 million on the primary market in view of the small number of new issues in that month). The purchases until then are in line with the target of acquiring around €5 bn of covered bonds by month for twelve months.

Generally, the purchase programme has contributed to invigorating the primary covered bond market which had been virtually at a standstill since September 2008. In fact, since it was announced in May it began to have positive effects by increasing issuance and cutting yield spreads. Since then covered bonds have been issued in Spain, France and Germany, but also in countries where, until then, issuance had been quite limited, as has been the case in Portugal, the Netherlands and Italy.

Trading activity on the secondary market has improved slightly although it remains relatively moderate. Yield spreads on covered bonds have narrowed notably as a result of increased demand, especially for issuers with higher spreads. For example, the spread of high-quality Spanish mortgage covered bonds over the three-year midswap rate decreased from 100 bp on the date the programme was announced to 30 bp at the end of August.

… and the larger ones have issued debt without need for any State guarantee.

The debt market is progressively opening for large institutions (in 2009 various Spanish institutions managed to issue €12.6 billion of debt without a State guarantee, Chart 2.5.A). The difficulties in accessing the market are still apparent in the amount of the issues backed by State guarantee, which, from February 2009 (when the first one was launched) to mid-September amounted to the €39 billion, spread among 39 institutions in differing proportions.

Fund raising continues to be a factor of vulnerability, but to a lesser extent due to the improvement in the markets and, in the case of Spanish banks, to the concentration of maturities in the medium and long term.

The improvement in international financial markets, along with a wholesale funding policy concentrated on the medium and long term (Chart 2.5.B), reduces the risk for Spanish institutions stemming from the problems of raising funds. However, the same as for the institutions of other European banking systems, this is still a latent risk, albeit mitigated by the public measures adopted.

The funds obtained from the Eurosystem by Spanish institutions account for a small proportion of their balance sheet.

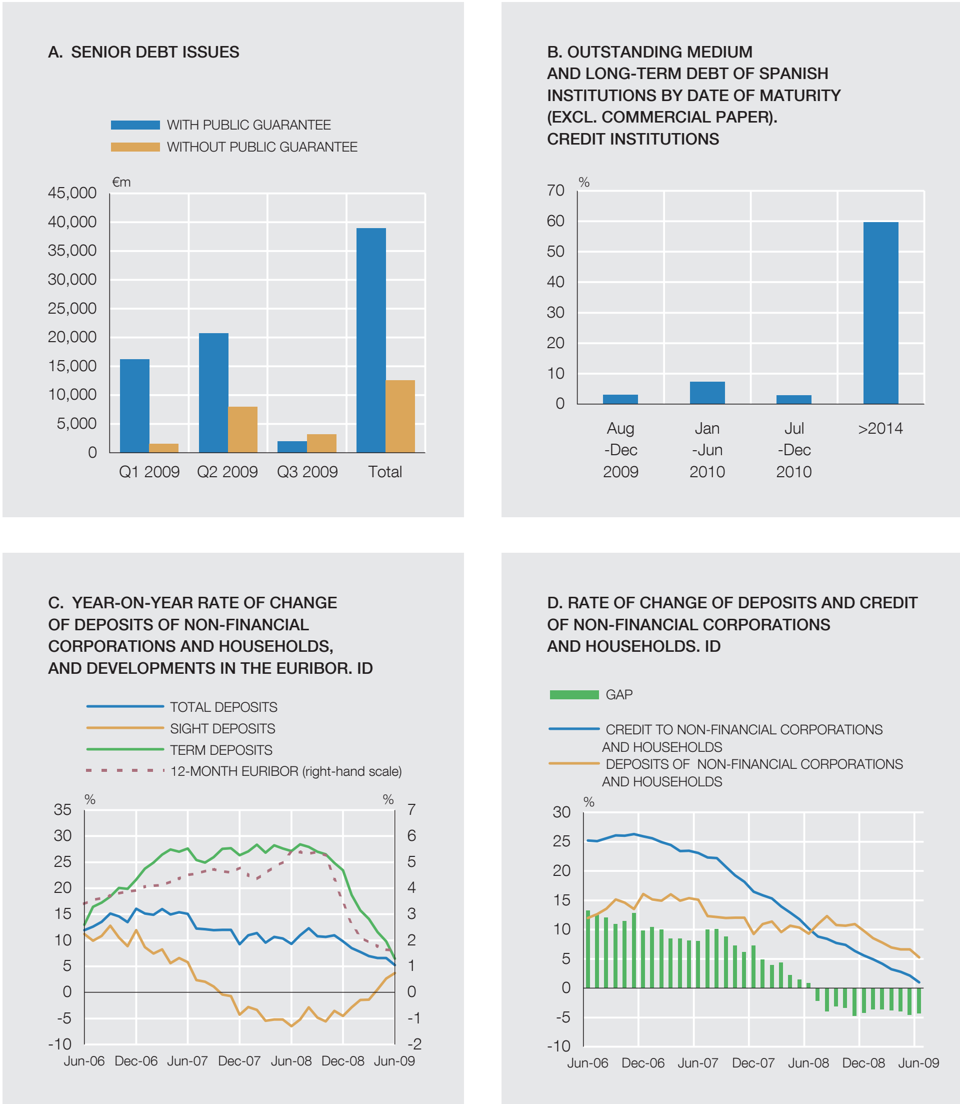
The same as other euro area institutions, Spanish deposit institutions have been obtaining more liquidity from the Eurosystem since the financial crisis broke out. However, the increasing rate of those requests for liquidity, which is in line with the size of the Spanish economy in the euro area, seems to have levelled off since February 2009, and, more importantly, continues to account for a small proportion of the consolidated balance sheet (1.9% in June 2009).

Spanish institutions have stepped up their efforts to attract deposits, which is made easier for them by their business model.

The drastic changes in the funding markets following the crisis have led Spanish institutions to undertake a progressive restructuring of liabilities. To do this they have stepped up their efforts to attract deposits, thus strengthening their already traditionally robust retail funding base. This has been made easier for them by their retail traditional business which involves a close relationship with customers and flexibility to change their product mix, since they sell a high proportion of pension funds, investment funds and insurance.

WHOLESALE FINANCING AND DEPOSITS
Deposit institutions

CHART 2.5



SOURCES: Market information and Banco de España.

Deposits continue to grow more than loans.

Time deposits of non-financial corporations and households were growing at rates around 25% until December 2008, when, as noted in the last FSR, their rates of change moderated (5.5% in July 2009 and 4% in August 2009). The moderation of time deposit growth rates, which coincided with the onset of interest rate falls, was offset by the recovery of demand deposits (Chart 2.5.C). Total deposits taken from non-financial corporations and households, despite slower growth in recent months, continue to expand more rapidly than loans (Chart 2.5.D).

2.1.2 PROFITABILITY

The financial difficulties and those of the real economy continued to put downward pressure on income statements.

Spanish deposit institutions reported profit to June 2009 of €12,315 million (Table 2.2), down 18.6% on the same period a year earlier. The economic and financial setting, although improved, continues to be difficult and, indeed, numerous international financial institutions, despite improved interim results in 2009, have reported losses or drastic falls in earnings.

In the medium term the pressure on Spanish

From the standpoint of the medium term, income statement margins will come under downward pressure. In the medium term, it does not seem feasible that business volumes will grow

INCOME STATEMENT
Deposit institutions

TABLE 2.2

	JUN-08		JUN-08	JUN-09
	€m	% CHANGE JUN-09/ JUN-08	% ATA	% ATA
Financial revenue	78,757	-4.0	5.31	4.57
Financial costs	43,010	-21.1	3.53	2.50
Net interest income	35,747	30.2	1.78	2.07
Return from capital instruments	1,502	-5.4	0.10	0.09
Share of profit or loss of entities accounted for using the equity method	1,277	-49.7	0.16	0.07
Net commissions	10,944	-0.6	0.71	0.63
Gains and losses on financial assets and liabilities	5,863	-1.9	0.39	0.34
Other operating income	205	-37.3	0.02	0.01
Gross income	55,538	13.6	3.17	3.22
Operating expenses	22,990	9.4	1.36	1.33
Net operating income	32,548	16.7	1.81	1.89
Asset impairment losses (specific and general provisions)	15,221	83.3	0.54	0.88
Provisioning expense (net)	903	-26.2	0.08	0.05
Operating profit	16,424	-10.5	1.19	0.95
Asset impairment losses (assets other than loans and credits)	1,309	639.6	0.01	0.08
Income from disposals (net)	1,155	-23.2	0.10	0.07
Profit before tax	16,270	-17.3	1.27	0.94
Net income	13,165	-17.6	1.03	0.76
MEMORANDUM ITEM				
Income attributable to the controlling entity	12,315	-18.6	0.98	0.71

SOURCE: Banco de España.

institutions' results will come from the smaller volume of activity, the potential narrowing of interest rate spreads and the persistence of bad debts.

as fast as they have done in the past. Offsetting the more contained growth of activity by higher spreads between asset and liability interest rates, as has occurred in the past year, also seems to be an option which cannot be maintained to the same degree in the medium term. First, because if interest rates continue to be so low, loans will continue to adapt to these rates, while the capacity to keep reducing the cost of the deposits is more limited. Second, because if interest rates increase, this rise will probably pass through to costs more quickly than to the return on assets, at least during the transition to the new scenario. The downward pressure on income will intensify because bad debt growth has not yet run its course and therefore specific provisions will become another source of pressure in the coming quarters.

Despite the differing impact of these factors across institutions, the crisis has demonstrated the excess capacity with which the banking system has been operating.

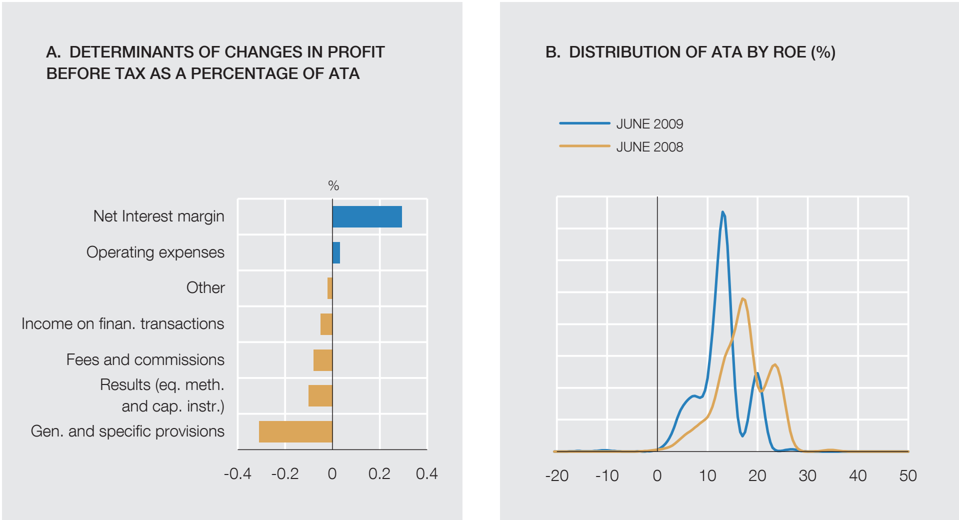
Hence the downside risk in the income statement confronting deposit institutions to varying degrees means that, depending on each institution's outlook for bad debts and profitability in the medium term, they will have to undertake restructuring to adapt their operating costs to the new environment. An important lesson to be learned from the financial crisis is that, both in Spain and abroad, the financial system has generated an excess capacity, a situation which has to be corrected to be in a position to face the medium term adequately.

In the first six months of 2009, the net profit attributed to the group decreased by 18.6% for deposit institutions as a whole,…

In the first six months of 2009, the *net income attributed to the group* decreased by 18.6% with respect to June 2008 (Table 2.2), which resulted in a fall in ROA from 0.98% to 0.71% (from 1.27% to 0.94% if ROA is calculated using consolidated profit before tax). The favourable performance of the net interest margin and the lower ratio of operating expenses to average total assets (ATA) were unable to offset the negative impact of the higher loan loss provi-

DETERMINANTS OF RESULTS AND DISTRIBUTION OF ROE
Deposit institutions

CHART 2.6



SOURCE: Banco de España.

sions, in consonance with the rising bad debts and, to a lesser extent, the sluggishness of fees and gains on financial assets and liabilities (Chart 2.6.A).

… putting downward pressure on ROE, although to a varying extent across institutions.

The lower profits put downward pressure on *ROE,* which decreased from 16.7% in June 2008 to 12.2% in June 2009. This general trend was not uniform across institutions, both due to the differences in the starting level of ROE, and to the differing ability to cope with the negative impact on their income statements (Chart 2.6.B).

The net interest margin grew strongly,…

The net *interest margin* grew strongly in June 2009 (30.2%). The extent of this growth was affected by changes in the scope of consolidation of a large institution, but even so the increase was across the board in all institutions.

… because financial revenue decreased less than financial costs.

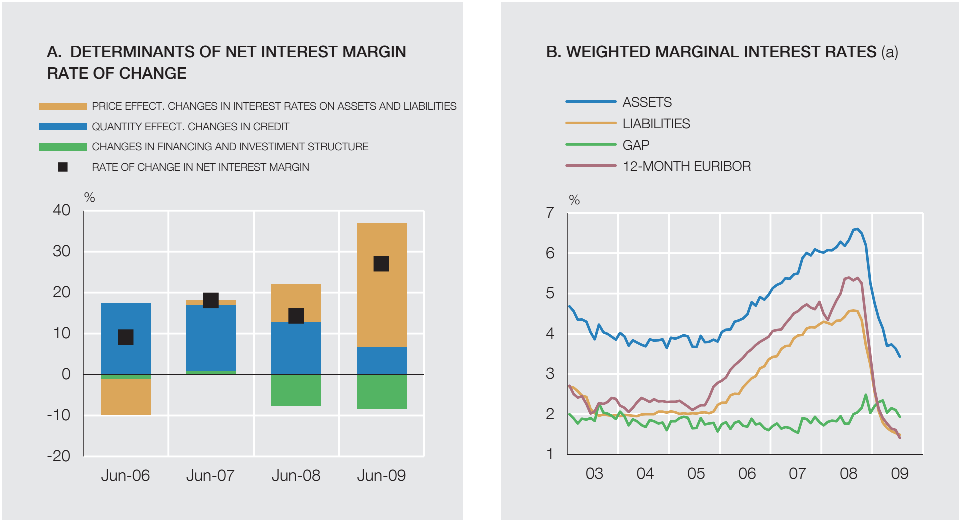
The growth of the net interest margin, which reflects the importance of traditional business for the Spanish banking system, as opposed to other systems whose results are more dependent on the performance of the financial markets, was made possible by the fact that financial revenue decreased (–4% in June 2009) by less than financial costs (–21.1% in June 2009). The interest rate reductions passed through to financial costs more than to the return on assets, and this offset the slowdown in lending activity. By contrast, the changes in the structure of funding on the liabilities side and of lending on the asset side acted to the detriment of the net interest margin, basically due to the increase in doubtful assets, since these cease to earn interest and thus lessen financial revenue (Chart 2.7.A). The data available on the rates applied to new loans and deposits (marginal rates) indicate that the spread between them has increased, although it is doubtful whether this trend will be sustained (Chart 2.7.B).

Commissions and gains on financial assets and liabilities decreased slightly.

The growth of the net interest margin passed through only partially to gross income (13.6% in June 2009). The *share of profit of entities accounted for using the equity method* decreased (–49.7%), due to the lower contribution from these companies as a result of the difficult current circumstances and because various institutions sold investments the income from which was recorded under this heading in June 2008. *Commissions* followed the trend noted in the previous FSR, decreasing slightly (–0.6% in June 2009). Those associated with activity (collection

NET INTEREST MARGIN
Deposit institutions. ID

CHART 2.7



SOURCE: Banco de España.

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

and payment services) grew moderately, while the persisting difficulties in the financial markets and the stiffer competition with traditional deposits to capture savings make securities operations less attractive and reduce the commissions associated with the sale of non-bank financial products. *Gains on financial assets and liabilities* decreased by 1.9%, partly because they were affected negatively by the income from disposals recorded by some institutions in June 2008.

Operating expenses held unchanged with respect to June 2008, thus improving the efficiency ratio.

Operating expenses grew less than ATA, although at a fast rate (9.4% in June 2009). This growth was greatly affected by the acquisitions made by a large institution. Excluding this institution from the analysis, operating expenses remained unchanged with respect to June 2008 (0.18%). In any event, the efficiency ratio improved from 43% in June 2008 to 41.4% in June 2009.

Institutions, depending on their financial position, have to put even more emphasis on processes which enable them to rationalise their operating costs.

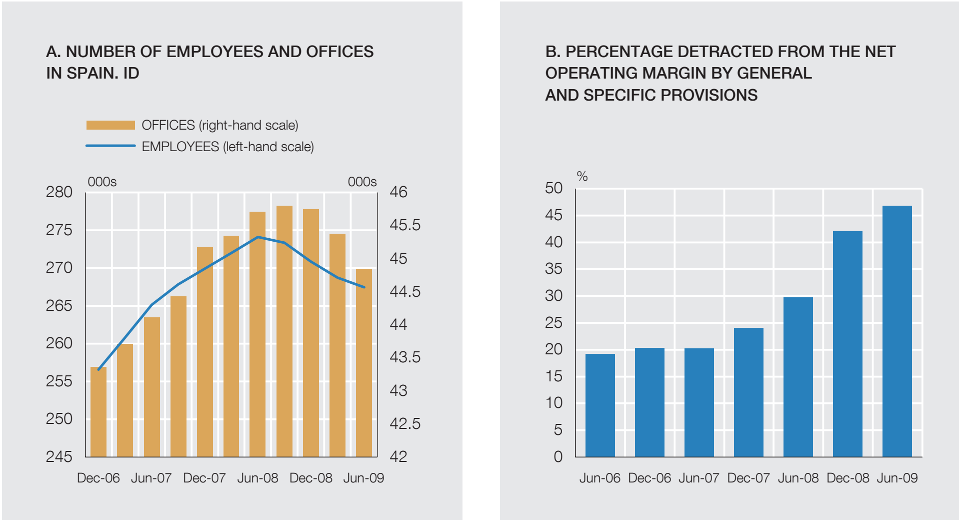
The moderation of operating costs expenses is reflected in the decrease in the number of offices and employees in the business in Spain (Chart 2.8.A and Box 2.4 for a European comparison), but this process, which will necessarily vary depending on the circumstances of each institution, has not yet acquired the necessary momentum given the downside risks to results. Institutions, depending on their financial position, have to put even more emphasis on processes which enable them to rationalise their operating costs. These processes involve adjustments to achieve the resizing needed against a background of slower growth of activity and of the economy in general.

The negative impact of specific provisioning due to rising bad debts explains why operating profit decreased by 10.5% in June 2009.

Operating profit fell by 10.5% due to the notable increase in *loan loss provisioning* (83.3% in June 2009), which reduced the operating margin by 46.7% (Chart 2.8.B). This increase in provisioning, offset only partly by dynamic provisions, is a consequence of the rise in bad debts (increase in specific provisions).

OPERATING EXPENSES AND PROVISIONS
Deposit institutions

CHART 2.8



SOURCE: Banco de España.

Spanish institutions still have higher ROE and efficiency levels than European institutions.

Comparison with the profits reported by European credit institutions as at December 2008 shows that Spanish institutions still maintain a better relative position in terms of ROE, which is negative for the EU as a whole (Chart 2.9.A). The better position of Spanish institutions is based on higher efficiency, a higher net interest margin and a smaller negative impact of gains and losses on financial assets and liabilities.

Both stock market prices and the risk of default derived from CDSs have improved in 2009.

The stock market performance of the major Spanish and European banks has improved in 2009 to date, as has the likelihood of losses derived from CDS spreads. The large Spanish banks performed better than their European peers (Chart 2.9.B).

2.1.3 SOLVENCY

The solvency of Spanish institutions improved in June 2009 and is higher than the minimum required.

As a whole Spanish deposit institutions ended 2009 H1 with a significant improvement in their *solvency* ratios which, consequently, remain above the regulatory minimum of 8%. More specifically, the total solvency ratio stood at 11.7%, 46 bp higher than in June 2008,[5] while the tier 1 ratio reached 9% (the minimum required is 4%), representing an increase of 86 bp[6] (Chart 2.10.A). Furthermore, the ratio comparing top quality tier 1 capital (capital and reserves net of goodwill) with capital requirements (the core capital ratio) also improved (from 6.8% in June 2008 to 7.5% in 2009).

This is a general improvement but there are differences between institutions as to the level and rate of the increase.

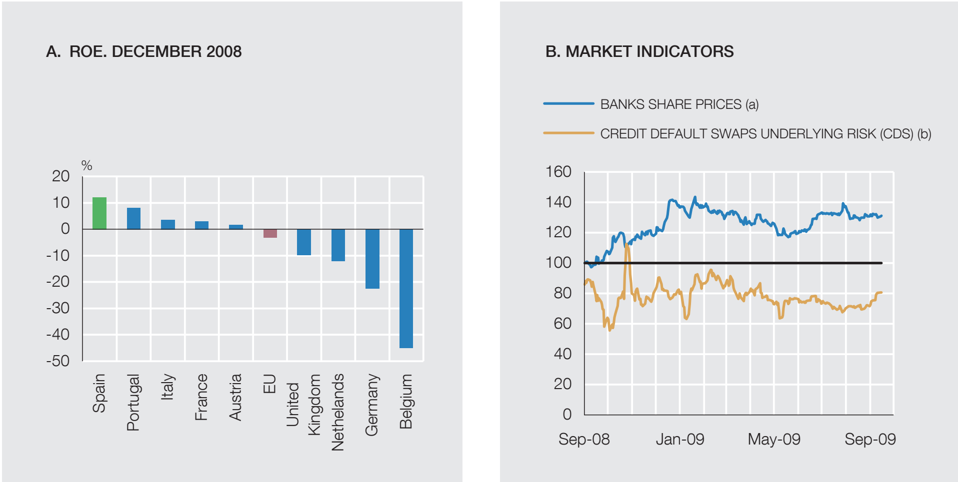
Solvency improved for a large number of institutions, both in terms of the total ratio and of the tier 1 ratio (Chart 2.10.B). However, the level of the two ratios at institutions is heterogeneous, reflecting their different strategies and financial ability.

The reason why the solvency of Spanish institutions has increased is because requirements have grown very moderately and less sharply than capital.

5. The data for June 2008 and June 2009 were calculated according to Banco de España Circular CBE 3/2008, which transposes into Spanish law the EU Directives including the changes introduced by Basel II on solvency regulations. **6.** Solvency levels of the Spanish banking system as a whole were not significantly affected by a large Spanish institution's acquisitions of foreign institutions. Thus, excluding this institution from the analysis, the solvency ratio would be 11.5% and the tier 1 ratio 9%.

INTERNATIONAL COMPARISON
Credit institutions

CHART 2.9



SOURCES: ECB, Datastream and Banco de España.

a. The series represents the ratio between the MADRID SE Bancos index and the DJ STOXX Banks index. Figures above 100 reflect a better perfomance of Spanish institutions.
b. The series represents the ratio between the average spread of CDS for major Spanish institutions and the average spread of CDS for major European institutions. Figures below 100 denote a better perfomance of major Spanish institutions in terms of risk.

Requirements grew moderately, to a large degree due to the slowdown in lending.

The moderate growth of *risk-weighted assets* (2.8% in June 2009) is in line with the slowdown in lending and none of its components were highly buoyant (Chart 2.11.A). Developments in requirements are explained by the rise in requirements for credit risk and, to a lesser degree, those for operational risk, while those related to market risk decreased due to the decline in exposures to equity securities.

Capital grew more than capital requirements…

The growth of total *own funds* moderated to 7%, 30 bp lower than one year ago, as a result of the slowdown of tier 1 capital (6 pp to 13.7%) and the reduction in tier 2 capital (–7.7%) (Chart 2.11.B).

… driven in particular by tier 1 capital.

Tier 1 grew following the strong increase in preference shares (23.4%), reserves (6.4%) and capital (23.2%), although the increase in capital can be largely attributed to private capital increases undertaken by certain large institutions (see Note 6, Chart 2.11.C).

In a setting as difficult as the current one, in which primary markets seem to request more capital from institutions, the latter have issued preference shares, thus strengthening their own funds. These issues have been favoured by the relative market improvement and, to a varying degree, institutions have also used their networks to place them among customers. The strengthening of tier 1 capital through preference shares has not prevented, as mentioned above, the core capital of the system as a whole from increasing.

Tier 2 capital fell, mainly due to the decline in eligible provisions as a result of the increase in specific provisions.

Tier 2 capital fell by 7.7%, (Chart 2.11.D), particularly notable was the strong drop in eligible provisions (–23.8%), due to the decrease of general provisions as a result of the increase in specific provisions (rise in doubtful assets). The decrease in corrections to valuation adjustments also had a negative impact, albeit to a lesser degree, due to lower capital gains.

THE NUMBER OF OFFICES IN THE SPANISH BANKING SYSTEM IN COMPARISON WITH OTHER EUROPEAN COUNTRIES

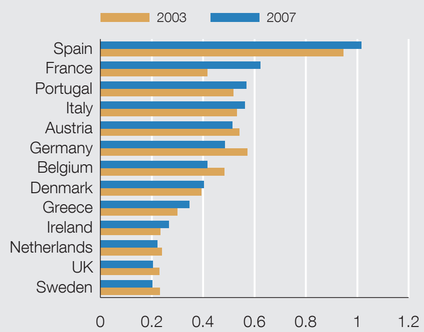
BOX 2.4

In comparison with other European banking systems, the Spanish banking sector is characterised by its high number of offices per number of inhabitants (Panel A), a situation which is slightly less differentiated when the offices per square kilometre are considered (Panel B). Likewise, the high number of offices per institution should be noted (Panel C), which employ a relatively low number of workers (Panel D). Assets per office are lower than in other banking systems (Panel E).

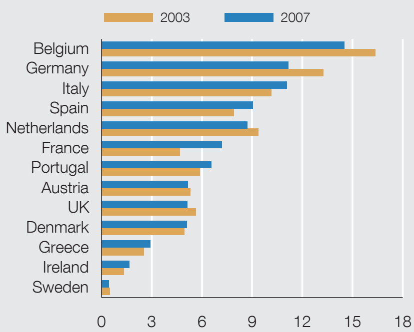
These characteristics have remained relatively stable between 2003 and 2007, and reflect countries' different banking models. The business performed by Spanish institutions is essentially retail banking which prioritises proximity to customers and building long-term relationships with them. Other banking systems with business models like the Spanish one are also more similar in terms of their office network, although their networks are not as extensive (Italy, Portugal and to a lesser degree, Greece and France).

The comparison of the number of offices with other European countries should not be interpreted as the need to follow the pattern prevailing in these other banking systems. However, this comparison, taken with due caution, does suggest that given the current circumstances, the institutions, depending on their particular situation, must restructure in a way that enables them to adjust their cost structure to a setting in which business volume will not be on a par with that of previous years. And all the more so given that the ongoing deleveraging will probably last for some time not only in the different banking systems but also in the different economies. Nevertheless, this adjustment of costs structures does not have to focus exclusively on the network but the costs associated with central services must also be taken into consideration.

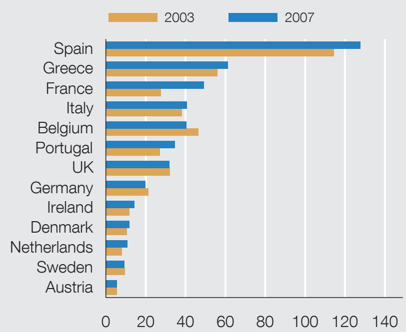
A. OFFICES PER 1,000 INHABITANTS



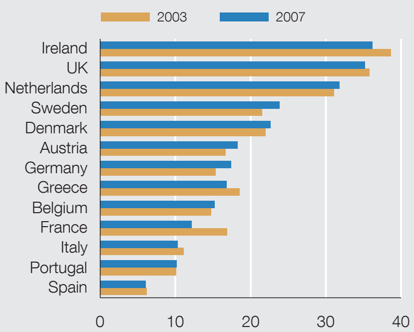
B. OFFICES PER KM SQUARE



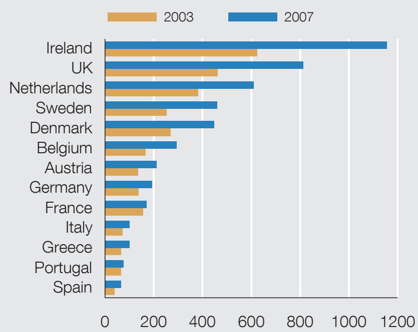
C. OFFICES PER INSTITUTION



D. EMPLOYEES PER OFFICE



E. TOTAL ASSETS (€m) PER OFFICE



SOURCE: EU Banking Structures, ECB, 2008.

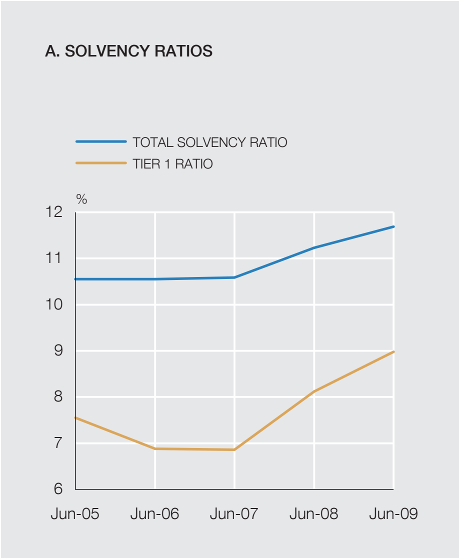
The Spanish banking system's solvency ratio was in an intermediate position in comparison with other European banking systems,…

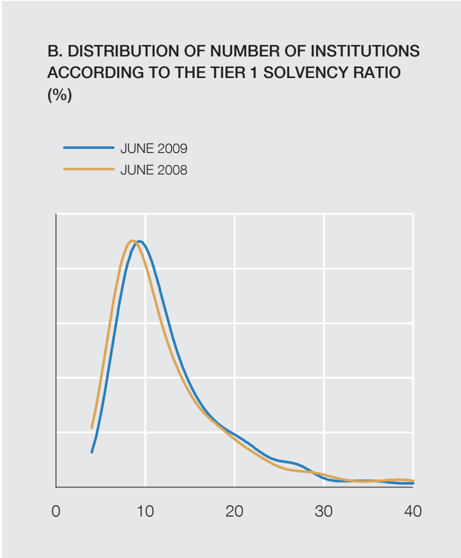
A comparison of the Spanish banking system's level of solvency with other European countries puts it in an intermediate position both in terms of the total solvency ratio and the tier 1 ratio (Chart 2.12. A). These data for December 2008 (the latest available data),[7] are affected by the fact that many large European institutions received public funds to strengthen their capital, which is not the case of Spanish institutions. In spite of this, the most recent data on large

7. ECB, "Europe Banking Sector Stability", August 2009.

SOLVENCY
Deposit institutions

CHART 2.10





SOURCE: Banco de España.

European institutions (published by the institutions and relating to 2009 H1), confirm that the tier 1 solvency of large Spanish institutions is in line with other banking systems in Europe.

…although Spanish institutions' level of leverage is lower.

As indicated in the last FSR, the international financial crisis underlined that institutions with a high solvency ratio had not been able to escape the serious consequences of the crisis's direct impact. The reasons for this are varied and include the extent of the excessive leverage, which is low in the case of the Spanish banking system in comparison with other European countries (Chart 2.12.B).

2.2 Insurance companies, investment funds and pension funds

Market and economic difficulties continue to affect the European insurance sector.

The difficulties besetting the European insurance sector throughout 2008, which resulted in downward pressure on its profits and solvency, continue at present. The international financial crisis has increased interest-rate risk and the risk arising from lower stock market prices, which have diminished due to the improvement in markets in 2009. The ongoing weak macroeconomic situation is also having a negative impact on the insurance sector.

Entities must take into consideration the risks arising from swine flu, although the public information available suggests these risks are containable.

There are other risks that the sector must take into account in its valuation models. In the life segment, a stronger-than-expected incidence of swine flu would have a negative impact, that would also affect medical insurance companies. In non-life, the complications would stem from the interruption of business at insured companies. In any event, currently available public information indicates that these elements of risk are containable.

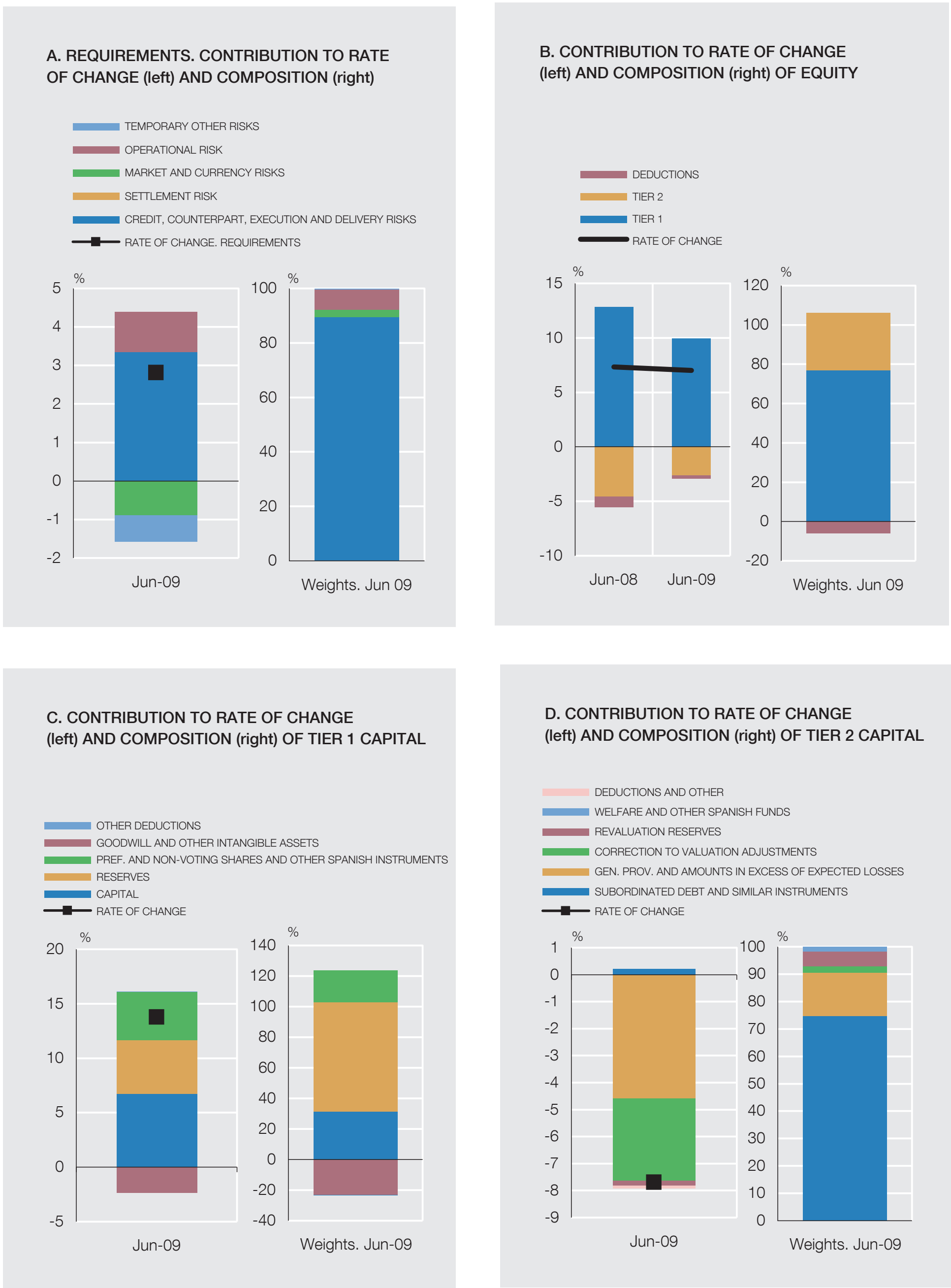
Spanish entities are also facing financial risks, albeit attenuated, and a deteriorating economic situation although their solvency margin is high.

As already indicated in the previous FSR, financial risks arising from the situation on international markets are also affecting the sector in Spain, which nevertheless shows some differentiating features that tend to cushion these risks, such as its limited exposure to equity securities. The situation of the real economy is having a negative effect on the sector as are low interest rates, making it difficult to attract business and causing the number of claims to rise. In any event, the solvency margin for the insurance sector as a whole stood at 242.2% in March 2009,[8] above the minimum required.

8. Data provided by ICEA (Investigación Cooperativa entre Entidades Aseguradoras y Fondos de Pensiones —Co-operative Research between Insurance Companies and Pension Funds).

SOLVENCY
Deposit institutions

CHART 2.11



SOURCE: Banco de España.

Premium growth was moderate and centred on the life segment but both life and non-life are subject to downward pressure

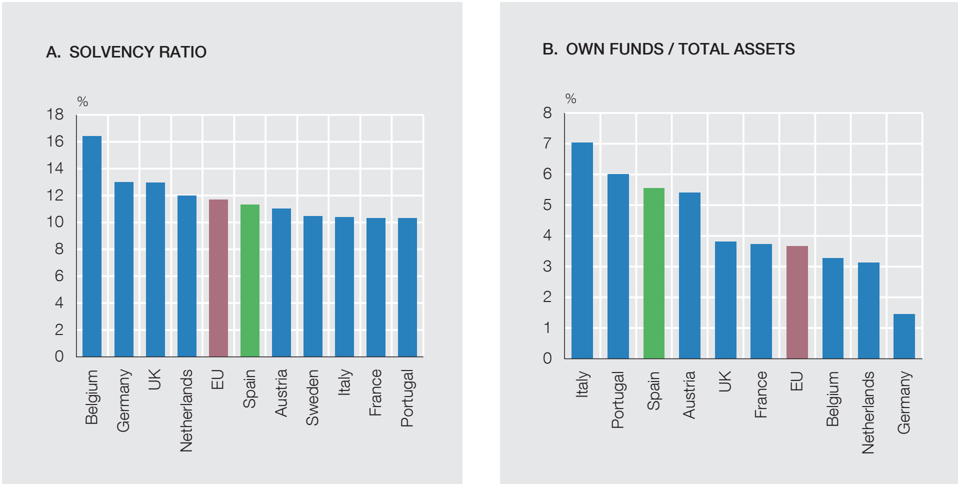
Available information on business developments to June 2009 indicate that the premiums for the sector as a whole have grown in comparison with the same period in 2008, although this growth was moderate and centred on the life segment which nevertheless has to adapt to falling demand, low interest rates and increased competition in attracting savings. In the non-life segment the decline in automobile sales negatively impacted this sector which has been partially offset by fewer claims. The worsening of the real economy has adversely affected multirisk home insurance, which is linked to housing loans and to the credit and suretyship insurance segment (in the latter case due to more claims).

Returns on investment funds have improved but

The international financial crisis has had a direct effect on the investment funds sector, resulting in negative returns and the withdrawal of funds, due, partly, to greater competition from

COMPARISON WITH EUROPEAN BANKS. DECEMBER 2008
Credit institutions

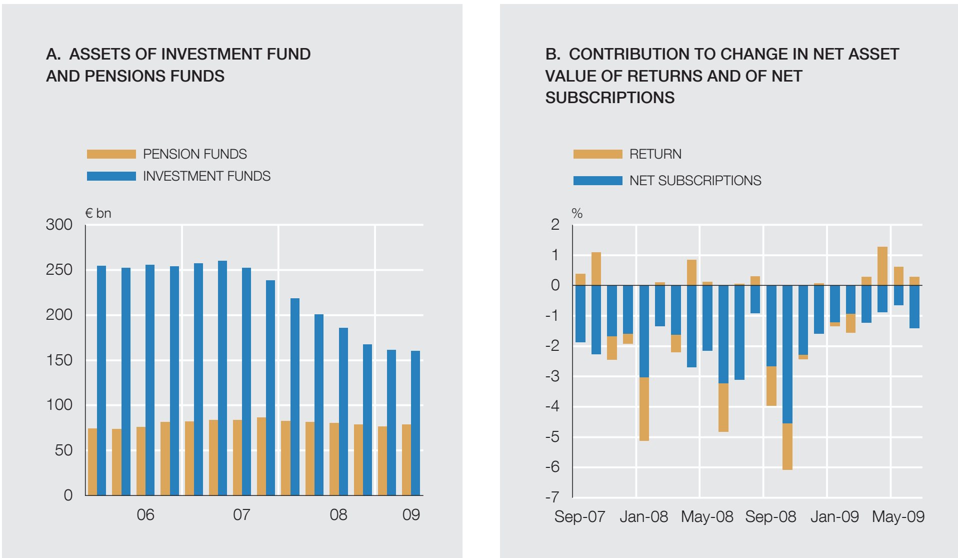
CHART 2.12



SOURCES: ECB and Banco de España.

INVESTMENT AND PENSION FUNDS

CHART 2.13



SOURCES: INVERCO and Banco de España.

withdrawals continue albeit more slowly.

more traditional banking products in attracting savings. In the first half of the year the sector's situation has improved which has led to a smaller fall in funds' net assets (Chart 2.13.A), net withdrawals of funds still continue albeit at a slower pace (Chart 2.13.B).

Given the long-term approach of pension funds, the trend in their net assets is more stable.

Although pension funds have also been subject to the pressure of international financial difficulties, and have benefited from recent improvements, the trend in their net assets is more stable over time (Chart 2.13.A), in keeping with a product type focused on long-term saving.

3 Other issues

The financial crisis has highlighted the need to review international coordination bodies in various fields.

The global nature of the financial crisis and the intensity and speed with which its effects have fed through to the real economy, in particular since September 2008, have highlighted the need to review international coordination bodies in various fields, including that of global financial stability oversight. To address this challenge the role of the G-20 has been reinforced, extending its scope and functions. Further, to give greater political weight to the decisions adopted, the G-20 began to call summit meetings of the Heads of State/Heads of Government of its members. The first of these Summits was in Washington in November 2008, where it was agreed: (1) to clarify the distribution of responsibilities between the International Monetary Fund (IMF) and the Financial Stability Forum (FSF); (2) to call on both institutions to reinforce collaboration; and (3) that the FSF should admit new members so as to reinforce the legitimacy of the decisions adopted. In March 2009 the FSF increased its membership, admitting all the G-20 countries that were not represented, Spain and the European Commission to its ranks. In late June this year it called the first meeting of the new extended FSF, which has been renamed as the Financial Stability Board (FSB).

The Financial Stability Forum has extended its membership and objectives, and has been renamed the Financial Stability Board (FSB).

The FSB is conceived as an institution geared to identifying the vulnerabilities of the financial system and to coordinating the response of national authorities and of the different international fora. Its aims are to advise and supervise the implementation of international regulatory and supervisory standards, to promote the development of supervisory colleges and to support the preparation of contingency plans for the management of cross-border financial crises.

In Europe the Larosière Group, created at the behest of the President of the European Commission in October 2008, set out a road map for defining a new supervisory framework.

In *Europe,* in order to draw up specific proposals to strengthen European supervisory agreements covering all financial sectors and to set up a more efficient, integrated and sustainable supervisory system, the President of the European Commission created a high-level group in October 2008 made up of seven independent experts and chaired by Jacques de Larosière. The Group's recommendations have defined the road to take to create a new financial supervisory framework in Europe.

The European Systemic Risk Board has been created. It will be responsible for macroprudential supervision, issuing warnings and recommendations and overseeing compliance therewith.

Substance is to be given to this new framework with the creation of a European Systemic Risk Board (ESRB). This body will be responsible for macroprudential supervision of the European financial system, with the aim of pre-empting and mitigating systemic risks, preventing financial risks spreading through the entire system, contributing to the sound functioning of the internal market and ensuring that the financial sector makes a sustainable contribution to economic growth. While there will be broad representation on the Board's General Council, which will include national supervisors, it will be the National Central Bank governors and the European Central Bank who adopt decisions, given their key role in financial stability matters. Further, the European Central Bank, with specialist assistance from supervisors and from the National Central Banks, will provide analytical, statistical, administrative and logistical support to this new Board. In the performance of its functions the ESRB will issue warnings and recommendations and oversee compliance therewith.

In the field of microprudential supervision, which remains the responsibility of the national authorities, the European

In the field of microprudential supervision, the European System of Financial Supervisors (ESFS) has been set up. The System comprises the national financial supervisors and three microprudential supervisory authorities, created drawing on the current European supervisory committees: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions

System of Financial Supervisors has been created to improve the quality and consistency of supervision in Europe.

Authority (EIOPA). The ESFS combines responsibility for the daily supervision of EU financial institutions, which remains the responsibility of the national authorities, with specific tasks at the European level geared to enhancing the quality and consistency of supervision, strengthening the supervision of cross-border groups, and setting in place a single set of rules applicable to all financial institutions. These new authorities may adopt legally binding decisions in specific cases relating to non-compliance with regulations and to disagreements between supervisors, and they will play a coordinating role in emergency situations.

Efficient collaboration between both agencies is vital.

Efficient collaboration between the ESRB and the ESFS will be vital if they are to function properly and ensure the interaction of the macro and micro levels of financial supervision, which is key to this reform. Legislative proposals to set this new framework in place were submitted last September and will foreseeably be approved in the Spring of 2010.

In other countries, such as the United States…

Regarding supervisory arrangements in other countries, significant changes have also been considered. In the *United States,* the Administration proposed a reform which is still under discussion in Congress. It envisages reformulating the complex institutional arrangements in place for supervision. Under this reform a Treasury-presided Financial Services Oversight Council shall be set up to coordinate the different agencies and to identify systemic risks. Further, the Federal Reserve shall identify and supervise all groups of a systemic nature (whether they are banks or not) and continue to supervise bank holding companies. Banks of a federal nature shall be supervised by the National Bank Supervisor, and a Financial Consumer Protection Agency shall be set up. The reform shall alter the procedure for systemic bank resolution, leaving the initiative for this type of action with the Treasury.

… and the United Kingdom, reformulating supervisory arrangements is also the subject of debate.

In the *United Kingdom,* the effectiveness of the tripartite supervisory arrangements has been questioned, giving rise to various initiatives such as the new Banking Act. This legislation will consolidate and improve bank resolution arrangements, and add the achievement of financial stability to the Bank of England's mandate. However, discussions are far from over. On one hand, the Treasury has considered the creation of a Financial Stability Board geared to discussing risks to the system as a whole and to proposing the pertinent measures to prevent risks in the long term. On the other, a Parliamentary Committee report has acknowledged the need to clarify the responsibilities of each of the three supervisory bodies, although it insists on the need to discuss beforehand the tools to address macrofinancial supervision.

Beyond these proposals to change the financial supervision architecture, international debate and reform also turn on more specific issues, such as the current capital adequacy framework (Box 3.1) and international accounting standards. In this latter connection, both the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have initiated steps to review international accounting standards. The aim of these reforms is to resolve the shortcomings highlighted by the international financial crisis as regards the accounting standards applied to prepare the corporate financial information directed at the capital markets. These reforms have been launched in the wake of the April 2009 G-20 communique. The IASB has set in train a three-phase project – currently at the discussion stage – to review the accounting of financial instruments. The FASB has also started work in this connection, though it is at a more preliminary and undefined stage. Further, and given the importance of the convergence of accounting standards, both Boards have undertaken to work together in achieving this aim.

RECENT REFORMS OF PILLARS 1, 2 AND 3 OF THE BASEL CAPITAL ACCORD

BOX 3.1

In November 2008, the Basel Committee of Banking Supervisors announced its intention to strengthen the Capital Accord in order to address the weaknesses relating to the regulation, supervision and management of bank risks that the financial crisis had highlighted. This intention coincided with the G-20 action plan drafted at the Washington summit on 15 November 2008. The G-20 called on the authorities to ensure that financial institutions have adequate capital to maintain confidence and urged international regulators to reinforce capital requirements for securitisations and structured products.

In January 2009, the BCBS published a consultation paper on a set of proposals to strengthen the Basel Capital Accord, including most notably improvements in Pillar 1 on minimum capital requirements, Pillar 2 on the supervisory review process and Pillar 3 on market discipline. On the closure of the consultation period, the Committee approved the final versions of the documents at its July 2009 meeting. The Pillar 1 and Pillar 3 measures will come into force in late 2010, while the Pillar 2 measures have taken immediate effect, following the joint publication of the documents.

The reforms to Pillar 1 relate to the treatment of the trading book and to capturing risk in securitisations and exposures to off-balance-sheet vehicles.

The new measures on capital requirements for the trading book include, among other changes, the introduction of a capital requirement for stressed VaR which will be added to the existing requirement for VaR. Further, replacing the former surcharge for event risk is the new charge for incremental default risk, which includes both default risk and that for the change in credit quality. Also, securitisations and resecuritisations[1] included in the trading book will be generally subject to the same requirements as those for the investment portfolio. A limited exception is envisaged for correlation trading, so that banks may develop models that capture incremental default risk, albeit subject to a very strict set of qualitative and quantitative requirements. Preliminary results show that capital requirements in respect of this portfolio might, on average, be between two and three times greater than the current requirements.

As regards securitisations and off-balance-sheet vehicles, the Committee's reforms include an increase in capital requirements for resecuritisations, as these proved to be a substantial source of losses during the crisis. Requirements have been raised in order to reflect their greater exposure to systemic risk and their complexity. In an attempt to reduce overconfidence in external ratings, the new regulations demand that banks should conduct more rigorous credit analyses of securitisations and resecuritisations, even when they have an external rating. Otherwise, capital requirements shall be increased. Lastly, some improvements have been made to the securitisations framework by eliminating the favourable treatment to short-term liquidity facilities extended to off-balance-sheet vehicles.

The Committee has also strengthened the Pillar 2 regulations in order to tackle the weaknesses detected in banks' corporate governance and risk management, and to ensure that the right incentives are set concerning employee remuneration, which should be linked to long-term results. The new Pillar 2 regulations require that banks: identify and manage their overall exposure to risks in a comprehensive manner; identify risk concentrations and aggregate all direct and indirect exposures to the same counterparty, and to related counterparties, geographical areas and industries; address reputational risk focusing mainly on the bank's liquidity position and on the non-contractual support to securitisations; improve valuation practices, especially for complex exposures recorded at fair value; and strengthen practices relating to stress exercises and capital planning. The principles on remuneration practices published by the Financial Stability Board have also been included. Adequate remuneration is a subject of particular interest to the Committee and one on which it continues to work.

Finally, the set of measures approved includes reforms to Pillar 3 on market discipline. During the crisis, the lack of transparency of structured products and of the risk and capital adequacy profiles of the banks investing in them posed an obstacle to market discipline. The additional disclosure requirements refer to securitisation exposures in the trading book, the sponsorship of off-balance-sheet vehicles, resecuritisation exposures, risks associated with the creation of securitisable portfolios and securitisation valuations.

This raft of measures approved in July is part of a broader programme whose aim is to strengthen the regulation of the banking industry and on which the BCBS continues to work. The work under way relates to enhancing the quality, consistency and transparency of capital within Tier 1: the introduction of a leverage ratio as a supplementary measure and of a minimum liquidity standard; measures to reduce procyclicality and recommendations to reduce the systemic risk associated with the resolution of international banks. The design of the measures proposed for the different areas should be finalised by end-2009 with a view to studying their impact and calibration over the course of 2010.

1. A resecuritisation is understood to be a securitisation in which at least one of the underlying exposures is in turn a securitisation.

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