An extensive restructuring of the Spanish financial system in 2011 saw the virtual disappearance of savings banks as credit institutions with direct financial activity (DFA). This process commenced in the previous financial year with the approval of Royal Decree-Law 11/2010, which instituted a new organisational model for savings banks based on transferring their business to a commercial bank and opting for the status of a credit institution without DFA. Subsequently, with the application of Royal Decree-Law 2/2011, most savings banks became mere holders of bank shares, occasional industrial and real estate investments, and welfare fund assets.[1]

Simultaneously, Royal Decree-Law 2/2011 stipulated, in anticipation of the Basel III Accord, that CIs must hold *capital principal* – a narrower concept than that of tier 1 capital under this Accord – equal to not less than 8 % of their total risk-weighted exposures. This requirement is 10 % for institutions that have not placed equity securities representing at least 20 % of their capital with third parties and that have a wholesale funding ratio[2] of more than 20 %. The institutions that at the date of entry into force of the Royal Decree-Law (10 March 2011) did not meet the applicable level of *capital principal* had to submit – for approval by the Banco de España – plans envisaging the progressive receipt of funds from third parties, their eventual market flotation, or the application for financial support from the FROB.[3] In the case of savings banks and of commercial banks held jointly by savings banks (IPS model), financial support from the FROB was made conditional on the transfer of financial activity to a commercial bank.

Commercial banks complied with the own funds requirements under Royal Decree-Law 2/2011 without much difficulty by means of capital increases (totalling €734 million) and the issuance of mandatorily convertible bonds (€333 million). By contrast, savings banks had to raise external funding for a significantly higher amount (€15,949 million), which was a factor in hastening the reorganisation of their consolidated groups, in some cases around existing commercial banks and, in others, around newly formed ones.

In sum, of the 36 savings banks at end-2010, Cajasur was wound up and only six continued to engage directly in financial activities as at 31 December 2011. Furthermore, four commercial banks which received the financial business of savings banks required majority stakeholder support from the FROB.[4] The volume of assets of the savings banks without DFA, after their financial activity had been spun off to the successor commercial banks, amounted to €50 billion, of which €43.5 billion related to equity investments (mostly bank securities), and €3.1 billion to welfare fund assets, while own funds amounted to €35 billion.

Savings banks without DFA have purely foundational features in their balance sheets and income statements that give rise to duplication in the aggregate equity and profit figures,

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1 See Chapter 1 of this Report and Chapter 3.2 of the 2010 *Report on Banking Supervision in Spain.*
2 Defined as the ratio of net wholesale funding of available liquid assets to loans and advances to other debtors. The detailed rules are contained in Banco de España Circular 2/2011.
3 This Decree-Law extended the FROB's functions to strengthen institutions' own funds without the need for this to automatically involve a merger and concentration process as envisaged by Royal Decree-Law 9/2009. Thus, it may adopt financial support measures such as acquiring ordinary shares of capital stock.
4 The "FROB institutions", and their consolidated groups, referred to in Annexes 2 and 3 consist of the four commercial banks created as successors to savings banks (Banco CAM, Catalunya Banc, NCG Banco and UNNIM Banc) and a subsidiary commercial bank of a savings bank (Banco de Valencia) which are majority owned by the FROB.

making it advisable to exclude them from financial and solvency analyses of credit institutions as a whole. *Unless expressly stated otherwise, the information presented in Annexes 2 and 3 refers to individual CIs with DFA (hereafter "CIs") and to CGs excluding independent CIs without DFA (hereafter "CGs").*

The restructuring and transformation of the banking system took place in an unfavourable macroeconomic environment (marked by lower GDP growth in Spain than in the euro area and by persistent difficulties in wholesale funding), which brought with it the stagnation of CI *activity* and sluggish balance sheet growth for CGs. Thus consolidated assets suffered a further fall in customer loans (recorded in the balance sheet item "Loans and advances to other debtors"), except in business abroad where they continued to grow, albeit more moderately than in previous years. In consolidated liabilities, deposits decreased, although less so than at individual level, as the recourse to traditional interbank markets was increasingly replaced by funding on the money markets through counterparties and by funding obtained from central banks. Equity increased (considerably at individual level and less so at consolidated level) as a result of the measures to strengthen the financial system and of the requirements derived from the stress tests conducted by the EBA.

2011 also saw a continuation of the contractionary trend in the main margins and items of the *income* statements of CIs and CGs. Broadly, the fall in income from intermediation activity and the recognition of greater impairment losses on financial and non-financial assets reduced the profitability of institutions, whose main indicators fell to historically low values. Also, the efficiency ratio worsened for the third year running, despite efforts to contain operating costs, as a result of the drop in gross income. At disaggregated level, commercial banks and savings banks – at individual level – and the larger CGs were yet another year the segments with the best profit-after-tax figures.

Turning to the *solvency* of CGs, total own funds decreased slightly in 2011. This was the result of an increase in tier 1 capital, a fall in tier 2 capital and a decrease in deductions from both. Thus the gain in weight of higher-quality own funds continued. The increase in the latter was closely linked to the restructuring of the sector and to the appetite for instruments of higher quality from a prudential standpoint. As regards capital requirements, all their main components decreased, although requirements for credit, counterparty credit and dilution risks and free deliveries contributed most to the fall in the total. These latter decreased despite slight growth in exposure values. It thus resulted from a decrease in the average risk weight which in turn resulted from falls in the average risk weights applicable to their components; specifically, in those applicable to requirements under the standardised and IRB approaches (in both cases, excluding securitisation positions). In the first case, the decrease in this average risk weight arose mainly from a redistribution of exposures, while in the second case it was mainly due to a fall in the average risk weights of some exposure classes, particularly the "corporate" class.

2.1 Activity of credit institutions and their consolidated groups

In a difficult situation marked by economic stagnation, by lack of confidence and by uncertainty inhibiting the normal functioning of national and international financial markets and by greater regulatory requirements in all the basic areas of banking activity, the Spanish banking system definitively embarked in 2011 on a rapid and drastic process of restructuring and, in particular, of savings bank consolidation and transformation. This transformative process had begun in the previous year under Royal Decree-Law 11/2010 and was spurred by Royal Decree-Law 2/2011. As might be expected in such a complicated environment, the financial statements reflect the aforementioned conditions. Hence the total balance sheet of CIs showed growth of 2 % in annual terms, which becomes slightly negative if the aggregate CI balance sheet figures are adjusted for the following events: i) segregation of the net assets of savings banks without DFA (–€6.5 billion); (ii) inclusion in the banking system of a substantial part of the balance sheet of Criteria Caixacorp[5] (€15 billion); (iii) partial duplication of the capital of Bankia due to the holding of Banco Financiero y de Ahorros (–€7.7 billion); and (iv) the high growth of the assets-side balances of trading derivatives (€55 billion), with practically equal coincident growth in the liabilities-side balances (€51 billion).

Therefore, the slight fall in the business volumes of CIs recorded in previous years continued in 2011, although the CG balance sheet showed moderate year-on-year growth of 2.9 %, which would decrease to 1.5 % if the effect of the aforementioned high trading derivative growth at individual level were stripped out. Consequently, the growth of activity at individual level stood clearly below the expansion of 2.1 % in nominal GDP, and slightly below it at consolidated level (see panel A of Chart A.2.1).

Contributing yet another year to the sluggishness of CI financial activity were the significant impairment allowances and derecognitions of written-off assets, which in 2011 were basically recorded with a charge to income, unlike in 2010 when significant write-downs were made with a charge to reserves, basically at savings banks, associated with merger and institutional protection scheme (IPS) processes. These allowances and write-downs have, moreover, had a negative effect on own funds and on the volume of loans and advances to other debtors[6] (see Chart A.2.1).

Regarding the other major balance sheet items, the slight growth of 1.1 % in CI liabilities would become a decrease (–0.6 %) if the aforementioned effect of trading derivatives were stripped out. By contrast, their equity grew at a year-on-year rate of 16.5 % as CIs responded to the aforementioned measures to strengthen the financial system (see Chart A.3.2).

It should be noted that these changes in assets and liabilities include significant off-setting movements between different items which are largely a result of the difficult economic and regulatory environment in which institutions have pursued their activity. Thus, on the assets side there was significant growth of 65 % in deposits with the Eurosystem, earning very low interest rates, and simultaneous decreases in interbank deposits, both reflecting the mutual lack of confidence between interbank market participants and the perceived need to accumulate liquidity in the face of pervasive uncertainty about how the financial markets would evolve. It is also noteworthy that the increase of 13 % in the residual item “Other assets” on the assets side was due to the strong growth of foreclosed tangible assets (61 %).

Loans and advances to other debtors, which is the most important item on the assets side, making up 57.9 % of it, shrank by 3.5 %, continuing the downward path initiated in 2008. However, its main components behaved unevenly, in that credit to resident general government grew by 10.5 % (21.7 % in the previous year), while credit to the resident private sector decreased by 4.2 %. Within credit to the resident private sector in business in Spain, there was a continuation of the trend towards an increasing weight of household loans, basically for house purchase and refurbishing [+1.0 percentage points (pp)], while lending to business decreased, basically in the construction sector (–0.7 pp) (see Chart A.3.4).

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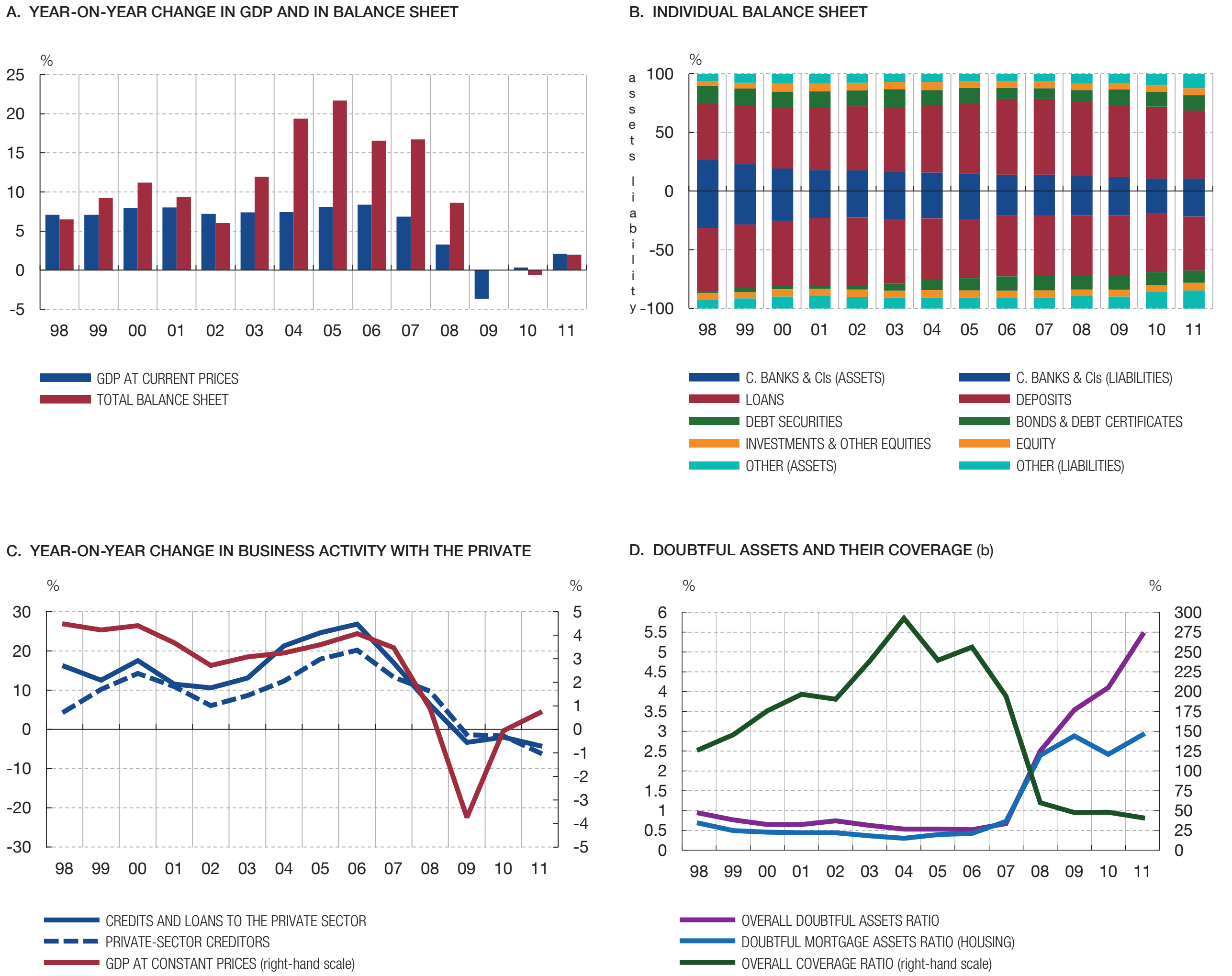
5 Criteria Caixacorp was a holding company of La Caixa, which absorbed Microbank and acquired its bank portfolio. Criteria Caixacorp subsequently received the banking business of La Caixa and became the current Caixabank, although it did segregate a minor part of its assets to La Caixa, which is now a savings bank without DFA.

6 The accounting rules stipulate that assets have to be reflected on the balance sheet net of the related loss provisions.

ACTIVITY OF CREDIT INSTITUTIONS WITH DFA (a) CHART A.2.1

Total business. Year-end data



SOURCE: Banco de España. Data available at 20 April 2012.

a The data in this chart refer to the institutions active at each year-end.
b The overall doubtful assets ratio is defined as doubtful assets as a percentage of total lending in the total business of CIs. The doubtful resident mortgage assets ratio is defined, for business in Spain, as doubtful assets as a percentage of credit to the resident private sector for house purchases. The overall coverage ratio is defined as the sum of allowances, provisions and valuation adjustements as a percentage of total doubtful assets.

Doubtful assets rose more quickly than in the three previous years. This growth, along with the fall-off in exposures, pushed up the overall doubtful assets ratio by 1.4 pp to 5.44 % in December 2011, the basic component being the doubtful loans to the resident private sector, the ratio of which was up by 2.1 pp to 8 %. By contrast, the doubtful assets ratio of household mortgage loans for house purchase and refurbishing stood at 2.9 %, undergoing only a slight annual rise of 0.3 pp, which continues to indicate relatively good payment behaviour in this segment. Against this background, the on-balance-sheet doubtful assets coverage ratio decreased by 6.7 pp to 41.1 % (see Table A.2.1 and panel D of Chart A.2.1). Although the increase in doubtful assets was general, it was most noticeable in the institutions controlled by the FROB, where the practically two-fold rise accounted for 41 % of the overall increase.

Investments is another item which showed high growth of 22 %, although its expansion was concentrated in the larger CIs. Also contributing to this was the partial duplication of

BREAKDOWN OF CHANGES IN OWN FUNDS, IMPAIRMENT ALLOWANCES AND WRITTEN-OFF ASSETS **TABLE A.2.1**

Yearly data

€m

	Total credit institutions with DFA		
	2009	2010	2011
DETAIL OF OWN FUNDS (a)			
Prior year balance	177,808	186,023	178,562
Total revenue and expenses recognised	13,547	10,945	1,955
Increase (decrease) in capital / endowment fund	5,195	8,236	52,047
Conversion of liabilities into own funds and other capital instrument increases	387	1,213	6,734
Distribution of dividends	–7,457	–7,194	–6,358
Other increases (decreases) in equity	–3,456	–20,661	–24,922
Of which: due to mergers, acquisitions and creation of IPSs	*—*	*–16,896*	*–25,619*
Final balance	186,023	178,562	208,018
IMPAIRMENT ALLOWANCES. LOANS (b)			
Prior year balance	45,097	53,131	71,988
Movements reflected in income statement	20,250	17,683	18,917
Other movements	–2,790	18,666	3,783
Balances used	–9,427	–17,493	–15,797
Final balance	53,131	71,988	78,891
MOVEMENT IN THE WRITTEN-OFF ASSETS ACCOUNT (c)			
Prior year balance	24,051	31,859	48,248
Additions charged to impairment allowances	9,510	17,670	16,034
Additions charged directly to income	1,525	1,693	2,058
Past-due income	1,150	1,868	1,898
Other	571	945	1,111
Total additions	12,756	22,175	21,101
Total reductions	–4,943	–5,807	–11,981
Net change due to exchange differences	–6	20	24
Final balance	31,859	48,248	57,392

SOURCE: Banco de España. Data available at 20 April 2012.

a Data from the statement of changes in equity. Confidential return A1.
b Data from breakdown of movements in impairment allowances. Confidential return T14.
c Data from movement of the written-off assets account during the current year. Confidential return T10.7.

capital in the aggregate figures of the individual institutions derived from the structure of the Bankia group, in which this bank is held by the BFA, which is a CI with DFA, which in turn is controlled by the seven savings banks now without DFA that gave rise to the group.

The liabilities side also showed uneven behaviour in its constituent items. Most noteworthy was the significant rise in the funding received from the Eurosystem as a result of the major refinancing operation with a maturity of 36 months conducted in December,[7] which is related to the aforementioned growth of deposits with central banks. There was also an

7 The recourse to Eurosystem financing was a result of an ECB decision taken in the fourth quarter of 2011 to implement long-term refinancing operations (LTROs), first with a maturity of 12 months and subsequently with a maturity of 36 months. Those LTROs, for an unlimited amount, entailed the provision of collateral and relaxation of the related requirements, and aimed to support liquidity and bank lending in the euro area in order to relieve wholesale market constraints.

increase of 27 % in the funding received from money market operations through counterparties, and these transactions were recorded under the "Other liabilities" item on the liabilities side, representing substantially all the total increase in this item. By contrast, the other liabilities-side items decreased, with falls in deposits from other creditors (–6.2 %), in debt certificates including bonds (–5.6 %) and in subordinated liabilities (–20.6 %), although the latter were affected by the exclusion of savings banks without DFA, which retained a portion of these subordinated liabilities, and by their conversion to new instruments eligible as high-quality own funds (including capital principal) under the new solvency rules (see Tables A.2.1 and A.3.2).

Own funds, the basic component of equity, increased by 16.5 %, or €29.6 billion. Here regard should be had to the partial duplication of the aggregate own funds of CIs arising for the first time in 2011 due to the aforementioned new structure of the Bankia group (duplication of capital items, seen also in other cases). This development largely stemmed from the new regulations to strengthen the financial system which, firstly, led to the detection of *capital principal* needs of €16.7 billion and prompted the aforementioned conversion of subordinated debt (not included in the definition of *capital principal)* into capital, and, secondly, stimulated the inflow of fresh capital into the system. The conversion of subordinated debt into capital (around €6.7 billion) was also advised by the advantages of share capital in terms of higher liquidity, and by the growing uncertainty as to the valuation of subordinated debt against a background in which this instrument increasingly shares the burden of maintaining CIs through the absorption of losses. The growth of own funds crystallised in capital increases of €52 billion, although approximately €25.6 billion were neutralised (including here the effect of Criteria) by the segregation of assets and liabilities from savings banks without DFA (see Chart A.2.1).

In 2011, the distribution by CI institutional group of the total balance sheet reflected profound changes in the credit system structure. At end-2011 the seven largest commercial and savings banks (foreign branches are excluded from this size segmentation) represented 55.7 % of the balance sheet of the system, the institutions in which the FROB has a holding accounted for 8.3 %, other commercial and savings banks for 30.2 % and credit cooperatives and SCIs for the remaining 5.6 %. Noteworthy in the seven largest institutions is the higher relative weight of deposits at (and funding received from) central banks, with growth of 80 % and 215 % in the year, credit to resident general government, the equity portfolio, the trading derivatives activity, business with central counterparty clearing houses and own funds; while decreases took place in activity in the traditional interbank market, fixed assets and tax assets, there being a fall in deposits from other creditors of 6.6 %, and the only increase was a 5 % rise in holdings of Spanish government debt (see Chart A.3.3).

In the institutions controlled by the FROB, due to the write-downs made by them, equity amounts to half of the weight that would be expected on the basis of balance sheet size, this shortfall being offset by interbank funding, customers' term deposits and subordinated debt; while, on the assets side, fixed assets and tax assets showed fairly high balances. Also significant were the fall of 9 % in deposits from other creditors, the increase of 80 % in positions in Spanish government debt and the increase of 150 % in funding received from central banks.

Noteworthy as regards other institutions, apart from the particularities of the balance sheet structure of foreign branches, are the following: the weight of credit to resident general government in foreign branches; that of funding received through savings accounts and the fixed assets in credit cooperatives; and, as is natural, that of credit secured by commercial collateral and transferred securitised assets in SCIs; the falls in deposits are around 6 % and the increase in recourse to central banks and holdings of government debt are more moderate at 66 % and 28 %, respectively.

As regards securitisations, there were significant changes compared with previous years despite the freezing of the markets for instruments of this type. New issues of asset-backed securities arising from traditional asset securitisations grew significantly (40.4 %), interrupting the downward path of previous years. However, there continued to be a sharp decline in CIs' liability securitisations (mortgage covered bonds), no longer included this year in Tables A.3.7 and A.3.8, which led to a fall of nearly 60 % in 2011 (–54 % in 2010). The new issues of asset-backed securities continued to be massively retained by the originating institutions for use as collateral to gain access to various sources of liquidity. None of the new securitisations entailed a significant transfer of credit risk and, consequently, did not affect the solvency ratio. Notably securitisations of residential and commercial mortgages lost weight in the past year, while, by contrast, those of corporate loans doubled and those of consumer loans and of other assets more than doubled. No new synthetic securitisations were carried out (see Chart A.3.7).

The outstanding balances of asset securitisations decreased slightly (–8.3 %). Most notable here were the falls of 89.8 % in the volume of commercial mortgage securitisations and of 34.2 % in the related commercial paper, while residential mortgage securitisations, which make up 64.5 % of the total, dropped less (–7.5 %). The reasons for this contraction seem to be economic and financial, the payment due upon the scheduled maturity and the reorganisation of the groups. Regarding the first reason, a point not to be overlooked is that the falls in asset-backed bond prices on the secondary markets (falls above and beyond those to be expected from impairment of the credit quality of the securitised portfolios) stimulate the originators to repurchase the outstanding securities at a gain (see Chart A.3.6).

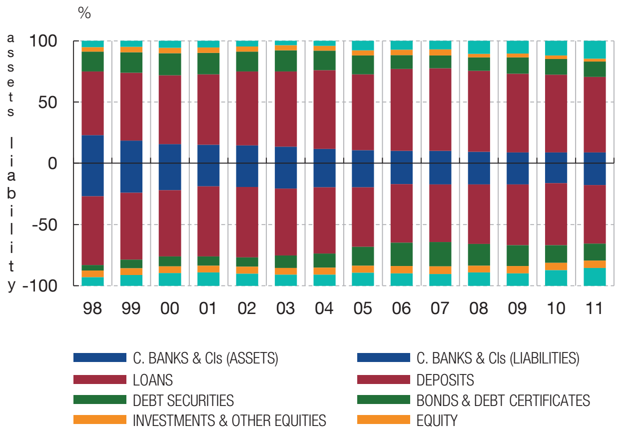
Finally, the total balance sheet of CGs exceeded €3.9 trillion at end-2011, posting a moderate year-on-year increase of 2.9 %, which, as mentioned above, would be trimmed to 1.5 % if the effect of the increases in trading derivatives recorded on the assets and liabilities sides were stripped out. This was so even though business in Spain only increased by 1.4 %, meaning that its share in total business receded by 1.1 pp to stand at 72.6 %. By comparison, business abroad grew by 7 %, partially driven yet another year by the acquisition of foreign banks by the large Spanish banking groups (see Tables A.3.5 and A.3.6).

The various asset items of the balance sheet generally performed as described at individual level, particularly insofar as business in Spain is concerned, with the exception that own funds only grew by 4.3 %, partly due to the stripping-out of the duplication of capital mentioned above for the aggregate figures of individual CIs. Certain differences are apparent between the total consolidated figure and its business-in-Spain component: in the case of the total consolidated figure the assets and liabilities vis-à-vis central banks increased to a lesser extent, while funding through central counterparty clearing houses grew to a greater extent, loans and advances to other debtors remained practically unchanged because growth abroad offset the shrinkage in Spain, and deposits from other creditors decreased to a lesser extent, all of which clearly demonstrated how the stabilisation of financial activity is favoured by the external diversification of CGs (see panel A of Chart A.2.2 and Table A.3.5). Thus, for CGs the loss of weight of business in Spain was

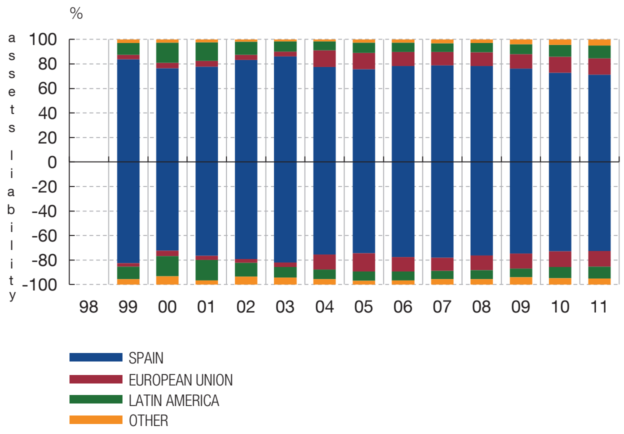
ACTIVITY OF CONSOLIDATED GROUPS WITH DFA (a) CHART A.2.2

Total business. Year-end data

A. CONSOLIDATED BALANCE SHEET



B. GEOGRAPHICAL DISTRIBUTION OF BUSINESS



SOURCE: Banco de España. Data available at 20 April 2012.

a The data in this chart refer to the CGs active at each year-end (note that they include individual CIs not belonging to any consolidated group).

more than offset by the growth of business abroad, mainly in Latin America and to a lesser extent in the EU. Financial assets and liabilities in Latin America grew by 7.4 % and 7.6 %, respectively, although the net assets managed there decreased by 5.1 % (see panel B of Chart A.2.2 and Table A.3.6).

2.2 Results of credit institutions and their consolidated groups

The complex macroeconomic setting in Spain in 2011 – which ended with negative quarter-on-quarter GDP growth – along with the adversities caused by the uncertainty derived from the euro area sovereign debt crisis – which affected, more than in previous years, countries such as Portugal, Italy and Spain – markedly weakened the results of Spanish credit institutions.

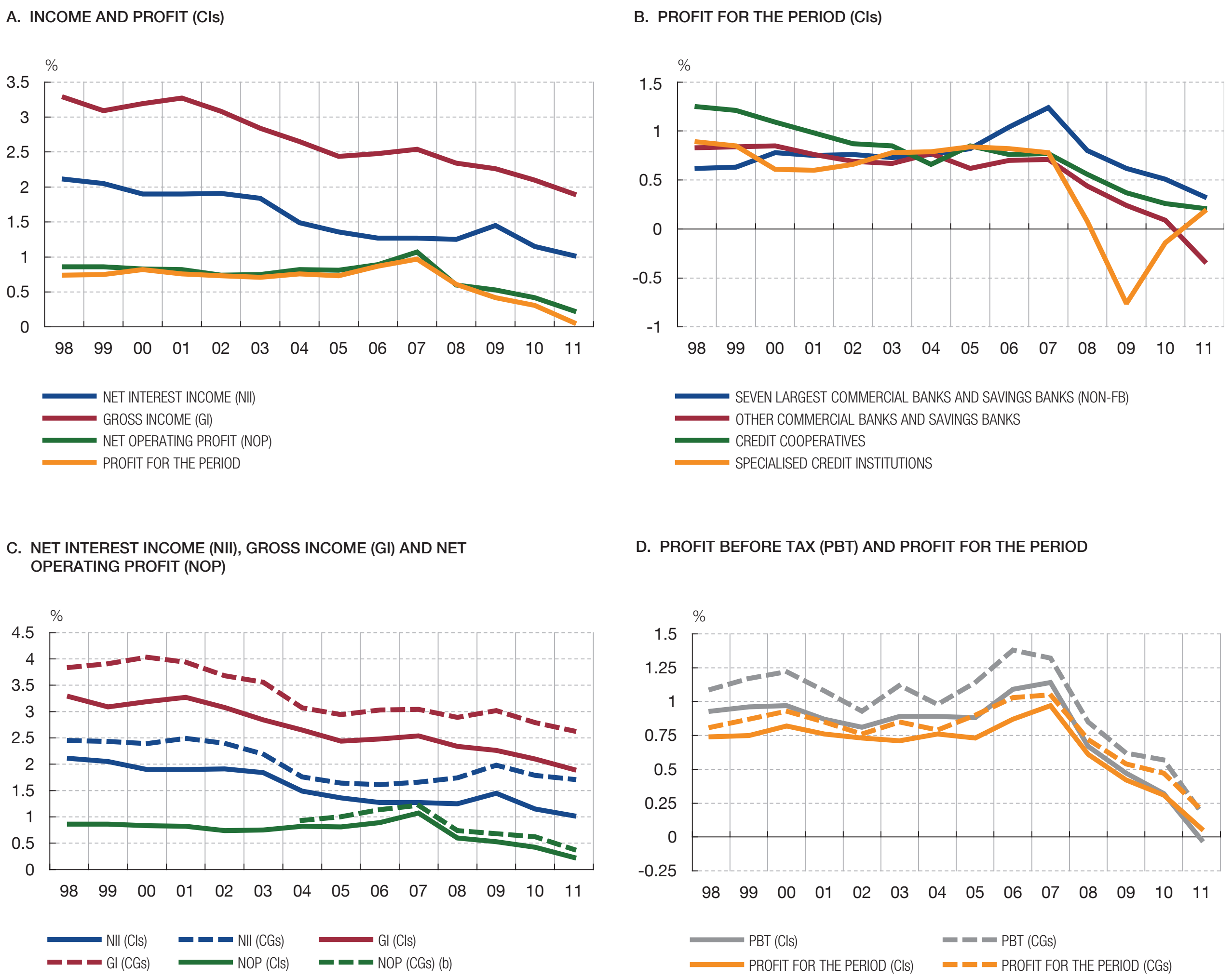
At end-2011 the individual income statements of CIs showed aggregate profit of €1,881 million, down 81 % from the previous year. The return on assets (ROA) decreased to 0.06 % (0.31 % in 2010), while the return on equity (ROE) dropped to 0.95 % (5.27 % in 2010). The efficiency ratio also performed worse, increasing by more than 4 pp to 50.2 % (see Chart A.3.9).

As in 2010, the reporting year ended with a decrease in all the margins of the income statement of CIs. Specifically, the falls in net interest income (NII) and gross income (GI) were relatively moderate (around 10 %), while net operating profit (NOP) and profit for the period fell substantially by 46.2 % and 80.9 %, respectively (see Chart A.2.3.A).

NII fell as a result of a rise in financial costs (26.7 %) outweighing that in financial income (9.1 %). The increase in NII (which amounted to €32,032 million) is explained, against a background of rising average interest rates, by a worsening of the total spread between the average return on earning financial assets (EFAs) and the average cost of interest-bearing financial liabilities (IBFLs), which narrowed from 1.29 % to 1.16 %. Also contributing somewhat more than 15 % to this fall was the sharp drop in EFAs financed by own funds, as was apparent from the fall in the contribution of this component to NII to €1 billion, compared with €1.6 billion in 2010 (see Chart A.2.4.A).

PROFIT AND MARGINS OF CREDIT INSTITUTIONS AND OF CONSOLIDATED GROUPS WITH DFA (a) CHART A.2.3

Percentage of ATA. Yearly data



SOURCE: Banco de España. Data available at 20 April 2012.

a The data in this chart refer to the institutions active at some time during each year. The label “CIs” denotes individual data. In the case of data referring to CGs, note that they include individual CIs not belonging to any CG (for the period 2011 stand-alone CIs with DFA).

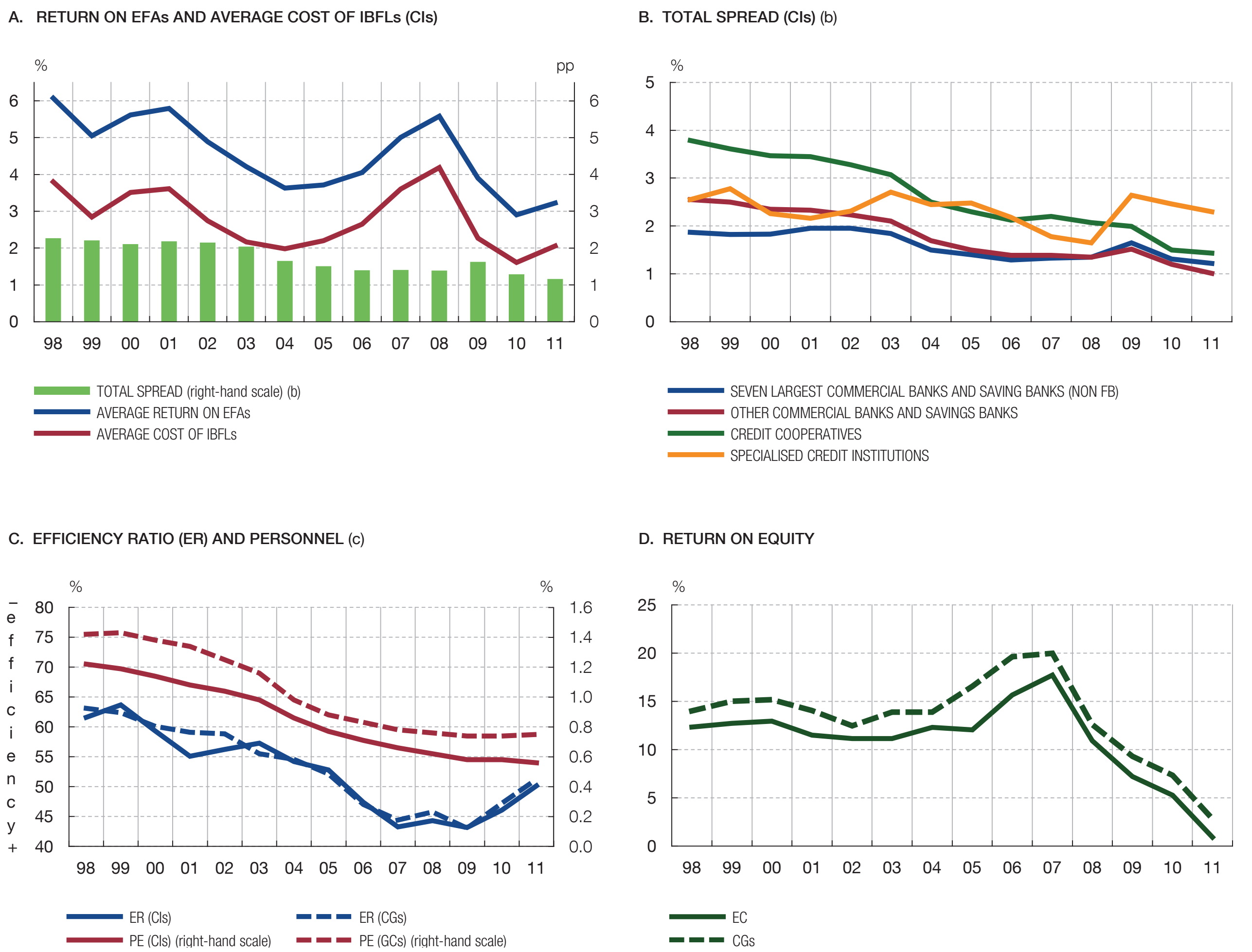
b Uniform information is not available for the NOM of CGs for years prior to 2004 due to the conceptual changes introduced jointly by Banco de España circulars 4/2004 and 6/2008.

The aforementioned growth of average interest rates was associated not only with the loss of Spanish CIs’ wholesale and interbank funding channels, but also with the collateral effects of the European sovereign debt crisis, which put upward pressure on Spanish sovereign debt interest rates and risk premiums. Moreover, these developments raised the volatility of financial asset prices. This environment of highly restricted access to funding by Spanish CIs and from other countries, in terms of both amount and price, forced them to again resort to funding from the Eurosystem.

In 2011 official interest rates fluctuated between 1 % and 1.5 % (+/–0.75 pp for loan/deposit facilities, respectively) as a result of two decisions to raise them and two to lower them by the ECB Governing Council, leaving the benchmark rate – both at the beginning and at the end of the year – at 1 %. To supplement this action, in December the ECB took various temporary measures to mitigate the prevailing financing pressure. These included refinancing operations with maturities of thirty-six months, greater eligibility of assets as

RETURNS AND EFFICIENCY OF CREDIT INSTITUTIONS AND OF CONSOLIDATED GROUPS WITH DFA (a) CHART A.2.4

Percentage of ATA. Yearly data



SOURCE: Banco de España. Data available at 20 April 2012.

a The data in this chart refer to the institutions active at some time during each year. The label "CIs" denotes individual data. In the case of data referring to CGs, note that they include individual CIs not belonging to any CG (for the period 2011 stand-alone CIs with DFA).

b Total spread is defined as the average return on earning financial assets (EFAs) minus the average cost of interest-bearing financial liabilities (IBFLs).

c The efficiency ratio is defined as administrative expenses and amortisation divided by gross income. Personnel expenses are expressed as a percentage of ATA (absolute values).

collateral in monetary policy operations (through the flexibilisation the rating requirement imposed on certain collateralised securities – ABS –) and the reduction of the reserve requirement (from 2 % to 1 %).

The caption below NII, which is return on equity instruments, scarcely changed in 2011, and thus could not neutralise the fall in non-interest income, which was driven by income from financial assets and liabilities and by exchange differences. As a result GI stood at 1.90 % of ATA (20 bp less than in 2010). As already noted in the previous year, net fee and commission income remained relatively steady at aggregate level, revealing that the higher charges applied by institutions in 2011 counteracted the drop in volume of these activities.

The aforementioned performance of GI is the main factor responsible for the NOP of CIs decreasing in both absolute terms (–46.2 %) and relative terms (–19 bp) to stand at 0.23 %

of ATA. The notable containment of administrative and amortisation expenses (down by €859 million overall) was insufficient to neutralise the decrease in the denominator (GI), so the efficiency ratio returned to a level (50.2 %) comparable to that of 2005 (see panel C of Chart A.2.4). It should, however, be pointed out that the downward trend in staff and office numbers (with the exception of some EU institutions operating as a branch in Spain) initiated in 2008, in parallel with the process (still under way) of banking system restructuring and concentration, is laying the foundations for an improvement in efficiency once profits return to levels more in consonance with CIs' normal activity.

Profit before tax (PBT) in 2011 was, for the first time, negative for CIs (–€582 million) as a result of the higher impairment losses on other assets (particularly investments) and of smaller gains on tangible fixed assets and real estate investments. This negative PBT does not pass through to profit for the period due to the effect of offset of deferred tax assets, which in turn gives rise to positive corporate income tax of €2,485 million. This adjustment is basically concentrated in the "Other commercial and savings banks – FROB" segment (see Chart A.3.10[8]). Both PBT and profit for the period examined at disaggregated individual-institution level show an appreciable dispersion, as shown by panel B of Chart A.2.3.

Analysis of the CI income statement by segment shows a structurally uneven performance among the commercial and savings banks controlled by the FROB, which is the only grouping systematically below the average in all income statement items. By contrast credit cooperatives and specialised credit institutions performed relatively well. Despite their greater sensitivity to increases in non-performing loans, in 2011 SCIs returned to profit after two consecutive years of losses at the levels of NOP, PBT and profit for the period.

The trends described above for the income statements of CIs also apply to CGs, whose profit for the period decreased by 56.9 % with respect to 2010, to stand at €7,698 million (see Chart A.3.11). The resulting decline in ROE (2.85 %) was also accompanied by a worsening of the efficiency ratio, which reached 51.3 %. However, the CG income statement shows, as in previous years, a substantially higher performance than that of CIs as a whole. Singularly in 2011 this pattern is apparent in the positive figure for PBT (€7,151 million). The profitability gap in ROE terms between CIs and CGs held at around 2 pp (see panel D of Chart A.2.4).

Lastly, the ATA of CGs increased in 2011 by 1 % (compared with –1 % for CIs) as a result of the increase posted by the six largest CGs (see Chart A.3.12[9]). The process of geographical diversification of the banking business continued through diverse transactions to take full or partial holdings in institutions based both in and outside the EU. Significantly, the volume of Spanish CGs' bank assets abroad shows positive cumulative growth since 2008, in contrast to the process of disinvestment by the banking systems of the main EU countries.

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8 The breakdown of total CIs in Table A.3.10 – which in previous editions of the Report on Banking Supervision comprised the four institutional groupings (commercial banks, savings banks, credit cooperatives and SCIs) – has been replaced by a segmentation which combines size and institutional criteria, as follows: the seven largest commercial and savings banks (excluding foreign branches); other commercial and savings banks (distinguishing whether they are controlled by the FROB; credit cooperatives; and SCIs.

9 Note that in Table A.3.12 the size segmentation of CGs (based on volume of ATA) – used for the first time in last year's *Report on Banking Supervision in Spain* – has been modified to adapt it to the changes made in Table A.3.10, such that the information is broken down into the following groupings: the six largest CGs (which show a direct correspondence with the seven largest individual commercial and savings banks) and the other CGs, distinguishing here between those controlled by and those not controlled by the FROB.

2.3 Solvency of consolidated groups of credit institutions subject to compliance with the solvency ratio in Spain[10]

In 2011, the solvency ratio of the CGs stood at 12.4 %, up 0.5 pp on that in 2010 (see Table A.3.13 and Panel A of Chart A.2.5). This growth was the result of a very slight decline in total own funds (0.3 %) and a larger decrease in capital requirements (of 4.7 %), which increased the surplus of own funds to €87.2 billion (see Panel B of Chart A.2.5).

Changes in total own funds conceal mixed behaviour of their components: tier 1 capital increased and deductions from tier 1 and tier 2 capital decreased, which was counteracted by the decline in tier 2 capital.

Against an international and national backdrop in which regulators and markets continued to demand increases in the amount and quality of own funds,[11] the CGs continued to raise their tier 1 capital (3.9 %) and the weight of the latter in total own funds which, from the minimum in 2006 (65 %), has risen without interruption to 89 % in 2011 (see Panel C of Chart A.2.5). The components which contributed to a greater extent to the growth in tier 1 capital in 2011 were eligible capital (in particular, share premiums) and minority interests.

The increases recorded in these items are very closely linked to the Spanish financial system restructuring process and, in particular, in the case of the savings banks, to their integration, the transfer of their financial activity to banks and the acquisition of a stake in the latter's capital by third parties. Also contributing to the increase in share premiums, albeit in a smaller proportion, were the exchange or conversion, by large CGs, of hybrid instruments into ordinary shares, by increasing capital with a share premium. The hybrids item was noteworthy among those trimming tier 1 capital growth, and its decline was essentially linked to this type of transactions which convert hybrid instruments into others of higher quality from a prudential standpoint and which permit, for example, an increase in *capital principal.*[12] In this respect, note that the *capital principal* of CGs subject to the related capital requirement represented in 2011, 88.2 % of the whole of their tier 1 capital and 118.2 % of their *capital principal* requirements. Another option which permits increasing *capital principal* is the issuance of mandatorily convertible debt instruments such as those included under the heading "Other" of Table A.3.13. This heading was notable, together with those of share premiums and minority interests, among those which contributed most to the growth of tier 1 capital. The increase in this heading is concentrated at a small number of CGs, and approximately one-third of it relates to the FROB's[13] contributions to the own funds of one institution.

The items which contributed negatively to the changes in tier 1 capital and, to a greater degree than the above-mentioned item of hybrid instruments, included, most notably, interim profits or material losses of the current financial year, which fell by 72.2 %. Also con-

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10 In this section, the abbreviation CGs is used to refer to consolidated groups of credit institutions and to individual credit institutions with direct financial activity not belonging to any consolidated group subject to compliance with the solvency ratio. Consequently, it excludes the institutions 2409 CAM, 2417 Novacaixagalicia, 2418 CatalunyaCaixa and 2419 Unnim, which are individual credit institutions without direct financial activity that do not belong to any consolidated group subject to compliance with the solvency ratio. The entry into force in 2008 of Banco de España Circular 3/2008 of 22 May 2008 to credit institutions on determination and control of minimum own funds (hereafter "CBE 3/2008") gave rise to a certain break in the time series of the data analysed in this section, since those relating to 2008 onwards were reported by CGs in accordance with CBE 3/2008, while the data relating to prior years were reported under CBE 5/1993.

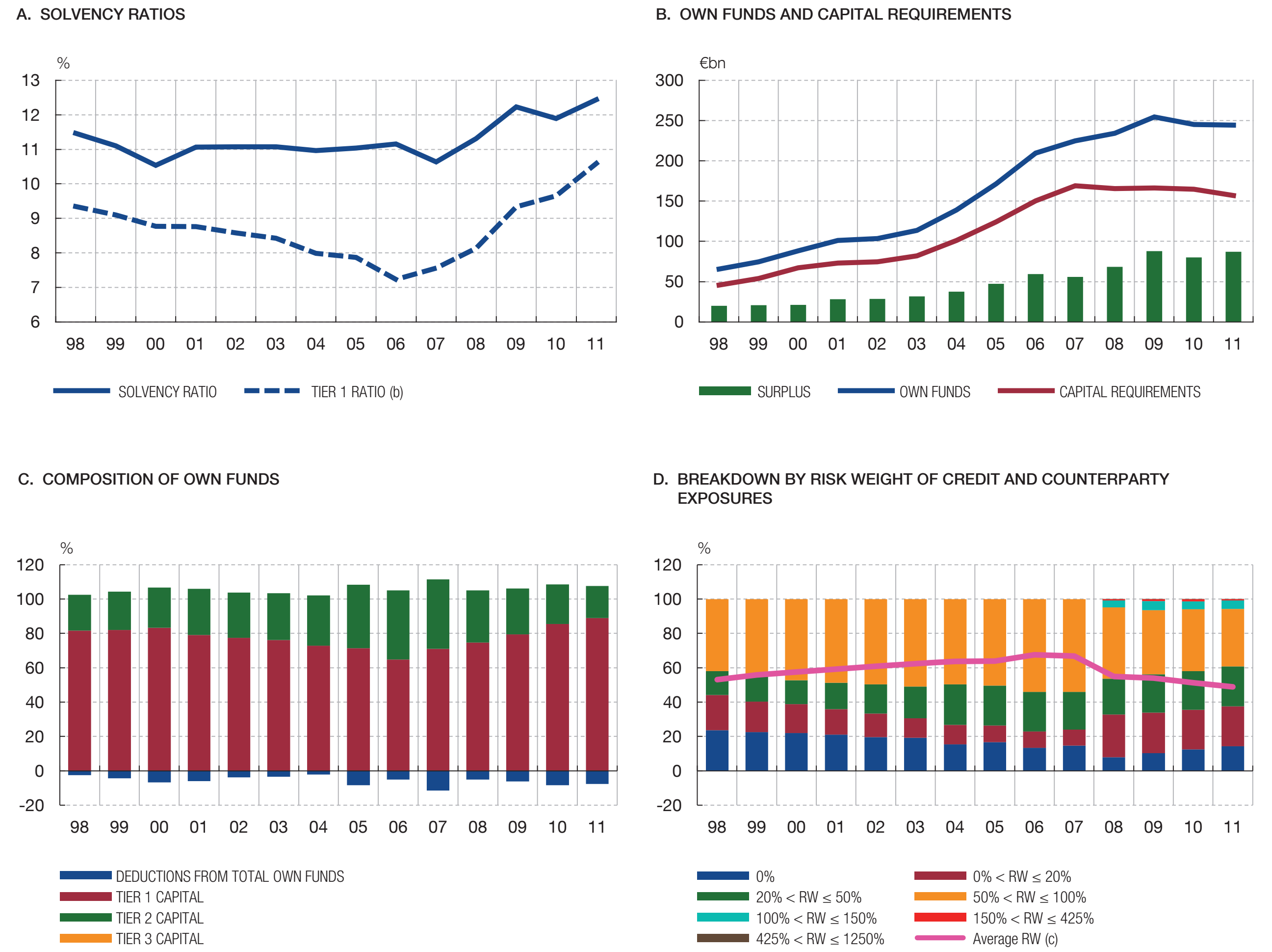
11 Noteworthy, internationally, is the European bank recapitalisation plan and, nationally, the *capital principal* requirements in accordance with Royal Decree-Law 2/2011 of 18 February 2011 for strengthening the financial system (see Box 1.1).

12 See Royal Decree-Law 2/2011 of 18 February 2011 for strengthening the financial system.

13 See Royal Decree-Law 9/2009 of 26 June 2009 on bank restructuring and the strengthening of own funds of credit institutions.

SOLVENCY OF CONSOLIDATED GROUPS WITH DFA (a) CHART A.2.5

Year-end data



SOURCE: Banco de España. Data available at 20 April 2012.

a The data in this chart refer to the CGs existing at each year-end. Note that, in the solvency section, this abbreviation is used to refer to consolidated groups of credit institutions and to individual credit institutions with direct financial activity not belonging to any consolidated group, subject to compliance with the solvency ratio.

b From 2008 onwards, the tier 1 ratio is calculated by subtracting from original own funds that part of the deductions from original and additional own funds that corresponds to original own funds. This calculation is not possible for data before 2008. For this reason, the tier 1 ratio for 2007 and prior years is calculated using total original own funds.

c See footnote (b) in Table A.3.14.

tributing negatively, to a lesser degree than the above-mentioned items, were the higher deductions from tier 1 capital, which corresponded practically in full to intangible assets, and the decline in reserves, against a backdrop of considerable balance sheet strengthening. Note that the deductions from tier 1 capital mentioned here are those that are only deducted from this component and do not include the portion of the heading "Deductions from original and additional own funds" which corresponds to tier 1 capital, a heading that is analysed below. Subtracting from the tier 1 capital analysed above, the portion of said heading which relates to it gives "original own funds (tier 1 capital) for general solvency purposes" is obtained whose growth stood at 4.6 %. The corresponding solvency ratio (tier 1 ratio as defined in footnote b of Table A.3.13) was 10.6 % in 2011, 0.9 pp up on 2010.

In contrast to the strengthening of CGs' tier 1 capital, tier 2 capital continued to follow a downward path, it decreased by 19.2 % and reduced its weight in the total by 4.3 pp to 18.7 pp. By component, supplementary additional own funds contributed most to this decline in 2011, in particular, subordinated loan capital, although core additional own funds also decreased significantly. Within the latter, the component "standardised approach (SA) general provisions and IRB provision excess" contributed to a higher degree to the decline, essentially through the drop in the general provisions related to exposures under the standardised approach, provisions which have had to be used as the losses on these exposures were materialised. The declines in securities of indeterminate duration and the other heading in Table A.3.13 (including the revaluation reserves and the funds of savings banks' welfare projects) are also worth underlining. The deductions from tier 2 capital, albeit lower than in 2011, had a practically imperceptible contribution, given their small weight. As in the case of tier 1 capital, these deductions are the deductions which are only applied to this component and do not include the portion of the heading "Deductions from original and additional own funds" which relates to tier 2 capital, heading that is analysed below.

The amount of the heading "Deductions from original and additional own funds" is distributed almost equally between original own funds (tier 1 capital) and additional own funds (tier 2 capital), although the respective halves account for 4.4 % of tier 1 capital and 20.2 % of tier 2 capital. Their combined performance prompted an increase in total own funds, essentially through: smaller excesses over 10 % of the capital of unconsolidated financial institutions in the holdings in such institutions; smaller excesses over 15 % of own funds in qualifying holdings in non-financial institutions; smaller deductions from securitisation positions to which a risk weight of 1250 % applies; and lower values under the heading which combines expected losses of equity exposures under the IRB approach and the IRB provision shortfall (in comparison with expected losses). Note, however, the increase in deductions for participations in insurance undertakings, reinsurance undertakings and insurance holding companies amounting to more than 20 % of their capital.

All the components of capital requirements contributed to the decline in 2011 (see Table A.3.14): requirements for credit, counterparty credit and dilution risks and free deliveries; requirements for position, foreign exchange and commodities risks; operational risk requirements and transitional, settlement and other capital requirements. However, the first component, which represents 87.9 %, contributed to a greater extent.

The decline in the requirements for credit risk occurred despite the slight growth in exposure values (0.5 %).[14] It therefore responded to the behaviour of the average risk weight, which fell from 51.3 % to 48.9 % (see panel D of Chart A.2.5). This fall was not the result of a distribution of exposures towards a method with lower average risk weights (i.e. a shift from the standardised approach to the IRB approach) – the effect of which was negligible – but of changes in the average risk weight of the components of credit risk requirements, specifically in the average risk weights of requirements for the standardised approach (excluding securitisation positions), and for the IRB approach (excluding securitisation positions) which, as described below, in turn, were due to different factors, although in both cases the corporate exposure class played an important role.

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14 Broadly, "exposure values" are the values which result once various effects have been taken into account which may give rise to a decrease in the original exposure value or to reallocations of the exposures to other categories with a different treatment for capital requirements purposes (effects such as those resulting from value adjustments and provisions, from the application of credit risk mitigation techniques or from the application of conversion factors to exposures in off-balance-sheet items). Multiplying the exposure values by the related risk weight gives the so-called "risk-weighted assets". The capital requirements for credit risk are calculated as 8 % of these "risk-weighted assets".

All the components of credit risk requirements – standardised approach (excluding securitisation positions), the IRB approach (excluding securitisation positions) and securitisation positions – recorded declines, although the largest portion of the reduction in total credit risk requirements is accounted for by the fall in the requirements calculated under the standardised approach (excluding securitisation positions). The latter decreased by 5.6 % as a result of the fall in the average risk weight, from 55.8 % to 52.4 %, which counteracted the slight increase in exposure values (0.6 %). In turn, approximately 80 % of said fall was explained by a redistribution of the weight of the exposure values by asset classes, which included, most notably, the increase in the weight of the central governments or central banks and similar categories (3.6 pp) and the decrease in the weight of the corporates category (3.7 pp). The average risk weightings for these two categories, which remained practically unchanged in 2011, are 6.5 % and 96.8 %, respectively. The corporate exposure class played a leading role in the decline of total requirements under the standardised approach, although noteworthy among the classes which contributed to countering the changes in these requirements was that of past-due items, whose requirements grew as a result of the rise in its exposure values.

The requirements under the IRB approach (excluding securitisation positions) fell more moderately (by 1.1 %). As with the standardised approach, the exposure values grew (1.7 %), but not sufficiently so as to offset the fall in the average risk weight of these exposures from 45 % to 43.8 %. Conversely, unlike the standardised approach, this fall in the average risk weight is not explained by a redistribution of weights across exposure classes which, in this case, occurred with an increase in the weight of classes with higher weighting (essentially, Retail) at the expense of classes with a lower weighting (Institutions). It is explained, fundamentally, by a decrease in the average risk weights of some of its components, in particular, that of exposures to Corporates (from 70.9 % to 67.7 %). This is the exposure class that was mainly responsible for the decline in the requirements under the IRB approach. The only category which contributed to countering the decline in IRB requirements was the Retail category, which posted an increase in its requirements as a result of higher exposure values.

Although the weight of requirements for securitisation positions is very low as a percentage of total capital requirements (1.3 % in 2011), it should be mentioned that they dropped by 13.4 % in 2011. In this case, unlike the two previous components, it was the changes in the exposure values (a fall of 24.8 %) that determined this decline. The effect of the redistribution of weights among its components (standardised approach and IRB approach) was negligible and the effect of the changes in the average risk weights of the components, acted in the opposite way to that of the decline in requirements with a highly significant increase in the average risk weight under the standardised approach which contributed to the total average risk weight[15] increasing from 46.8 % to 50.9 %.

Although the weight of requirements for position, foreign exchange and commodity risks is very low as a percentage of the total (3 % in 2011), it should be mentioned that they declined significantly (by 23.1 %), as a result of the lower requirements for foreign exchange risk resulting from smaller long positions in foreign currencies.

15 Note that a change has been introduced with respect to the 2010 *Report on Banking Supervision in Spain,* in the calculation of the average risk weight for securitisation positions. In this report, said calculation is performed after taking into account the impact of the limits on the requirements which would have applied to the securitised exposures had they not been securitised [see Note (e) of Table A.3.14].

Lastly, the capital requirements for operational risk, which represent 8.8 % in 2011, decreased by 2.3 % as a result of the decline in those calculated under the basic indicator approach and under advanced approaches, which countered the increase in requirements calculated under the standardised approach. The behaviour of requirements under the basic indicator approach reflected that of the so-called gross income[16] of the last three years, since these requirements are calculated as the average of the product of said gross income and a weight of 15 %.[17] Under the standardised approach, gross income is distributed by business line and the requirements are calculated by applying weights of between 12 % and 18 % to said gross income based on the business line. In 2011, the average weight[18] resulting from application of the standardised approach was approximately 13.4 %. In the case of the advanced approaches, although the related requirements are not the result of applying weights to gross income, a comparable weight can be estimated, which stood at 9.6 % in 2011.

16 Broadly, the so-called gross income is the result of grouping together certain items in the income statement of CGs.

17 Years in which gross income was not positive are excluded from the calculation.

18 Average weight calculated as total capital requirements under the standardised approach divided by the average total gross income of the last three years.