1 Evolution of the Spanish banking sector

The tables and data are to be found in the appendices to this document. The majority of the data come from Chapter 4 of the Bank of Spain’s Statistical Bulletin. The analysis of the Spanish banking sector is confined to banking business in Spain. The following are the main conclusions on the current situation and recent evolution of the Spanish banking system:

- The size of the system (total assets) has decreased by 14% since 2008 (Table 1), and by 19%, or €662 billion, since its peak in 2012. This decrease is proportionally less than that seen in lending, due to the increase in financial assets, both fixed income and equities, since 2008, and in particular the sovereign debt portfolio. From mid-2014 the volume of these portfolios started to diminish, and in 2015 it fell by 12%.

- Lending to the private sector ("Other Resident Sectors" in the statistics, hereinafter referred to in the English translation as "domestic private sector") continued to contract in 2015 (by 4% YoY). The cumulative reduction since 2008 is 29% (€543 billion, or 50% of GDP). Thus the deleveraging of the system continues (Table 1). The pace of decline has been moderating since the end of 2013.

- Lending to the domestic private sector has fallen across the board (Table 4), with notable declines in all portfolios, especially lending to businesses, with a cumulative reduction of 36% since 2008, and even more so in lending for construction and property development, which is down by 61%. Lending to households has fallen more moderately due to the greater duration of mortgage loans and the security normally associated with this type of lending.

- The total volume of deposits has fallen by 19% during the crisis (Table 1). However, the components of deposits directly linked to retail savings (current accounts and savings and term deposits) have remained much more stable since 2008 (Table 6), with a cumulative decline of 4% since 2008 and practically unchanged in 2015. The fall in total deposits is concentrated in more volatile components such as deposits of non-residents, repos, subordinated deposits and hybrid instruments.

- In 2015 there was a notable transfer of deposits from term deposits (-15%) to sight deposits (+17%) and savings accounts (+15%), as a result of expectations of very low interest rates for the next few quarters/years (Table 6).

- The volume of on-balance-sheet debt (-43% since 2008 and -10% in 2015, Table 1) continues to decline in line with the volume of lending and the consequent narrowing of the funding gap. The net amount of interbank lending (liabilities less assets) increased significantly during the initial years of the crisis due to Spanish institutions’ increased recourse to ECB liquidity when faced with the shut-down of other sources of financing. Requirements for interbank funding have moderated significantly from the peaks of 2012, in spite of the interbank market’s persistent fragmentation, which has not yet recovered its pre-crisis business volume.

- As regards ECB financing, it shows a declining trend from the peaks of August 2012 (since when it has decreased by 66%), which is compatible with institutions’ taking advantage of the liquidity provided by the conditional auctions (TLTROs), as well as of that which they obtain in ordinary open market operations of the ECB. Liquidity is no longer a problem for Spanish institutions. Banks are expected to increase their use of the new liquidity auctions announced last March 10th at very attractive prices to the detriment of the aforementioned non-conventional measures. Also, banks are to reduce other types of more expensive funding sources like on-balance sheet debt.
Installed capacity in the system continues to fall (Table 3) in line with the contraction in business volumes, the consolidation of the sector and the quest for greater operating efficiency and banking profitability. However, this process is almost completed and the speed of the reduction has slowed down.

Apart from this, the solvency of the system has been notably strengthened. Own funds (capital and retained earnings) have increased by 26% or €47 billion since 2008, despite after-tax losses of €94 billion having been posted during 2011 and 2012. The quality of the capital in the balance sheets has also improved.

The proportion of non-performing loans (NPLs) in the system continues to improve (Table 4) steadily despite the sharp contraction in lending to the domestic private sector, reaching 10.1% at the end of 2015. The volume of doubtful debt has declined for 24 months in a row, falling by €63 billion from its peak in December 2013, with €38 billion of this reduction posted in 2015, no doubt thanks to the start of the economic recovery. NPLs to construction and real estate companies continue to represent 41% of the total.

New lending transactions (Table 5) have shown a clear change of trend since the end of 2013 when they started to grow for the first time since 2007. In aggregate terms, all lending portfolios showed notable growth in 2015, including loans of more than a million euros to (large) companies. These companies were able to turn to other sources of financing during the crisis, such as the markets or intra-group financing, but in light of the favourable credit conditions they are once again starting to seek bank financing. Nevertheless, in the first month of 2016, the total volume of new lending fell slightly compared with January 2015, precisely because of lending to large companies (although it is still unclear whether this marks a change of trend). All the other portfolios maintained positive rates of growth. Since the end of 2013, therefore, the deleveraging of existing lending to the private sector has been compatible with the flow of new credit.

The interest rate environment continues to depress the profitability of the system. The prices of new transactions and of existing lending continue to fall significantly (Table 7). The rates recorded in January 2016 show falls in all portfolios, especially loans of less than a million euros to businesses (SMEs). These reductions cannot be offset by cheaper deposits (Table 8), the cost of which also falls in line with EURIBOR, but to a lesser extent than lending rates, as a result of which the customer spread also narrows.

As for the sector's results (Table 2), they continue to be depressed by the current environment, characterised as it is by lower business volumes, all-time low interest rates and increasing regulatory demands. Since the end of 2008 the system as a whole has carried out balance sheet clean-up operations (basically loan impairment losses, restructuring costs and value impairment of foreclosed assets) to the tune of €300 billion. In the first nine months of 2015 the gross margin fell by 4.9% relative to the same period of 2014, despite the stability shown by the interest margin and commissions.

Despite the sector's continuing priority attention to cost control, the net margin for the nine months to the end of September 2015 fell by 9.5% YoY due to the fall in net gains and losses on financial transactions. Additions to provisions continued to moderate in 2015, in line with the improving NPL situation and the volume of clean-up already carried out. Pre-tax profit and post-tax profit for the first nine months of 2015 were down by 5% and 14% YoY respectively.

As regard the main ratios (Table 9):

- The productivity of the system (volumes and pre-tax profit per office) remained at very high levels, as a result of which efficiency (cost income ratio) was 49.4%, thanks also to cost control. The volume of
operating costs as a percentage of Average Total Assets has been held below 1% since 2008 (Figure 6, Appendix 1).

- The sector's solvency is also improving. The volume of own funds (capital and reserves) reached 8.2% of the balance sheet total in December 2015, with the system's gearing also falling to 12.1x, compared with 18x in 2008. The volume of capital in the balance sheet has held steady throughout the crisis at above 100% of the volume of doubtful debt (Figure 2, Appendix 1), and since 2012 has increased by 169% (36 percentage points in 2015).

- Liquidity in the system is also improving. The loan to deposit ratio has fallen to 114%, 44 percentage points less than in 2008 (Figure 3, Appendix 1), placing the system at clearly sustainable levels. Additionally, the sector's funding gap (lending to the domestic private sector less deposits from the domestic private sector) continues to narrow, due to the notable deleveraging of the system and the stability of deposits, and is now at a similar level to that of 2001, and at an all-time low as a percentage of the balance sheet total.

- Requirements for additions to provisions are normalising, as reflected in the provisioning "effort" (additions to provisions / net income) and cost of risk (additions to provisions / total lending) indicators, which are back at pre-crisis levels (Figure 1, Appendix 1), which contributes to profitability's consolidating its position in positive territory following the losses of 2011 and 2012 (Figure 5, Appendix 1).

Comparing the evolution of the Spanish banking system with the average of EU banks (Appendix 2), the main conclusions are summarised hereunder, based on data from the “Risk Dashboard” of the European Banking Authority (EBA), which show the average of 57 of the main EU banking institutions that took part in the 2014 stress tests. The latest data available are for the fourth quarter of 2015.

- The strengths of the Spanish banking system since the end of 2009 (the date from which EBA data are available) have been a greater volume of capital in the balance sheet and a better cost/income ration than the average for European banks (Figures 1 and 5, Appendix 2).

- The most negative aspect is the trend in the NPL ratio, which is much higher in Spain and with faster growth (Figure 2, Appendix 2). Nonetheless, as has already been remarked, Spain's NPLs have now been falling for 24 consecutive months.

- The ROE of the Spanish banking system posted very negative levels in 2011 and 2012 due to the increase in the NPL rate and the additions to provisions required to clean up the system (Figure 4, Appendix 2). Since 2013 the profitability of the system has been similar to the average of European institutions, although slightly lower, as seems logical in a system with more capital in the balance sheet than the European average. These clean-ups were necessary in the Spanish banking system, as can be seen in Figure 3 in Appendix 2, which shows how the clean-up exercises brought coverage of NPLs by specific provisions to a level similar to the European average, where they subsequently remained, and which they have exceeded since mid-2014.

- Lastly, the loans-to-deposits ratio of the system in Spain has traditionally been higher than the EU average (Figure 6, Appendix 2), but since the end of 2012 the difference has narrowed significantly, in large part due to the transfer of assets to the SAREB (Spain's "bad bank").
DISCLAIMER
This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness. Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.
This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes. BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents. This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.
In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.
The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorised by BBVA.
This report has been produced by the Financial Systems Unit:

**Chief Economist for Financial Systems and Regulation**
Santiago Fernández de Lis
sfernandezdelis@bbva.com

**Financial Systems**
Ana Rubio
arubiog@bbva.com

Jaime Zurita
jaime.zurita@bbva.com

José Maria Álvarez
josemaria.alvarez.ines@bbva.com

With the contribution of:
Pablo Urbio
pablo.urbio@bbva.com

Rosa Gómez Churuca
rosa.gomez@bbva.com

**BBVA Research**

**Group Chief Economist**
Jorge Sicilia Serrano

**Developed Economies Area**
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

US
Nathaniel Karp
Nathaniel.Karp@bbva.com

**Emerging Markets Area**

Cross-Country Emerging Markets

Analysts
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano
Carlos.serranoh@bbva.com

Turkey
Alvaro Ortiz
alvaro.ortiz@bbva.com

LATAM Coordination
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

**Financial Systems and Regulation Area**
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Digital Regulation
Álvaro Martín
alvarojorge.martin@bbva.com

**Global Areas**

Economic Scenarios
Julían Cubero
julian.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

**Contact details:**
Azul Street, 4
La Vela Building - 4 and 5 floor
28050 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com