1 Trends and developments in 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 Statistical Bulletin of Banco de España, Spain's central bank. 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 trends and developments in the Spanish banking system:

Activity

- The system continues to contract (Table 1). Since 2008 balance sheet totals have fallen by 15%, and compared with the peak of 2012 the decline is 20% or €688 billion. This decrease is less than that in lending, due to the portfolios of financial assets, both fixed income and equities, and in particular the sovereign debt portfolio, which increased slightly in 2016.
- The total volume of deposits fell by 19% during the crisis (Table 1), but the stablest components of deposits (current accounts and savings and term deposits) have held up much better since 2008 (Table 6), with a cumulative decline of 3%. The fall in total deposits has been concentrated in more volatile components such as deposits of non-residents, repos, subordinated deposits and hybrid instruments. Since the beginning of 2015 we have seen a notable shift away from term deposits (down 16% YoY as of April 2016) and into sight deposits (+16%) and savings accounts (+13%), as a result of expectations of very low interest rates for the next few quarters or years (Table 6).
- The volume of on-balance-sheet debt remains on the downward trend which started in 2012 (down by 46% since 2008 and by 8% since one year ago, Table 1), in line with the volume of lending and the consequent narrowing of the funding gap. The net amount of interbank lending (liabilities less assets) has moderated considerably in the past three years following a period of substantial liquidity requirements met by the ECB for the banks finding it hardest to raise funds on international markets. Since the August 2012 peak, recourse to ECB liquidity has fallen by 68%. However, this 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.
- Installed capacity (basically the number of branches) 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.
- Apart from this, the solvency of the system has been strengthened over the past few years. Own funds (capital and retained earnings) have increased by 26% or €48 billion since 2008, despite after-tax losses of €94 billion in 2011 and 2012. The quality of the capital in the balance sheets has also improved.

Spotlight on lending and NPLs

- Lending to the private sector ("Other Resident Sectors" in the statistics, hereinafter referred to in the English translation as "domestic private sector") continues to contract in 2016. It has fallen by €38 billion YTD and is now down by 5% YoY. The cumulative reduction since 2008 is 31% (€586 billion, or 53% of GDP). Thus the process of 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 39% since 2008, and even more so in lending for construction and property development, which is down by 64%. 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 proportion of non-performing loans (NPLs) in the system continues to improve steadily (Table 4) despite the sharp contraction in lending to the domestic private sector, going below 10% for the first time since July 2012 to reach 9.91% in April 2016. The volume of doubtful debt has now declined for 28 months in a row, falling by €69.5 billion or 37% from its peak in December 2013. The major part (€38 billion) of this reduction came about in 2015 thanks to the start of the economic recovery. NPLs to construction and real estate companies continue to represent 40% 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 2015 all lending portfolios showed notable growth. This trend held in the first four months of 2016, except for new lending to major corporates, approximated by transactions of more than €1 million. These companies are able to turn to other, non-bank sources of financing such as the markets or intra-group financing. In the first four months of 2016 the total volume of new lending fell by 8% compared with the same period of 2015, precisely because of the decline in new lending to major corporates. All the other portfolios maintained positive rates of growth, especially new lending to households, which showed cumulative growth of 21% YoY to April. Since the end of 2013, therefore, the deleveraging of existing lending to the private sector has been compatible with the flow of new credit.

Results of the sector

- The interest rate environment continues to depress the profitability of the system. The prices of new transactions and of existing lending continue to fall (Table 7). Interest rates on new transactions recorded in April 2016 show falls in all portfolios, especially loans of less than €0.25 million and €1 million 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.
- The sector's results (Table 2) continue to be depressed by the 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 bad debts, restructuring costs and value impairment of foreclosed assets) to the tune of €308 billion. In the first quarter of 2016 the gross margin fell by 10% due to the decline in gains on financial transactions (-27% year-on-year). This downward trend in trading gains could not be offset by net interest revenue (which fell by 10% year-on-year in Q1'16) and fee and commission income, despite the latter's good performance in the quarter (+19%).
- Despite the sector's continuing priority attention to cost control, the net margin for the first quarter of 2016 was down by 18% year-on-year due to the fall in revenues. Additions to provisions continued to moderate in 2016, in line with the improving NPL situation and the volume of clean-up already carried out. Pre-tax profit and net profit for the first quarter of 2016 were down by 15% and 12% respectively year-on year.
- As regards the main ratios (Table 9):
  - The productivity of the system (volumes and pre-tax profit per office) remained at acceptable levels, so that the cost-to-income ratio was maintained at an excellent level of 50.5%, thanks also to cost control. Operating costs as a percentage of Average Total Assets have been held below 1% since 2008 (Figure 6, Appendix 1).
  - Additional improvements to the sector's solvency. The volume of own funds (capital and reserves) reached 8.3% of the balance sheet total in April 2016, with the system's gearing also falling to 12.1x, compared with 18.3x 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 to 178% as of April 2016.

- Liquidity in the system is also improving. The loan to deposit ratio has fallen to 112% as of April 2016, 46 pp less than in 2008 (Figure 3, Appendix 1). The sector's funding gap (lending to, 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 1999, 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).

International comparison

Comparing developments in the Spanish banking system with the average of EU banks (Appendix 2), the following are the main conclusions of the analysis of the 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 as at year-end 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 NPLs, which are much higher in Spain and with faster growth (Figure 2, Appendix 2). Nonetheless, as has already been remarked, Spain's NPL rate has now been falling for 27 consecutive months.
- In 2011 and 2012 the Spanish banking system posted heavily negative ROE 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.

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