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 Banco de España Statistical Bulletin. The analysis of the Spanish banking sector is confined to banking business in Spain (important: see footnote on page[1]).

Results of the sector

- The results of the Spanish banking sector in the first half of 2017 were heavily affected by the resolution and subsequent sale of Banco Popular to Banco Santander in June. According to data provided by Santander, Banco Popular posted losses of €12.13 billion in the half-year, due to several factors. The most important of these were: 1) €7.8 billion on cleaning up the real estate portfolio; 2) non-monetisable tax assets of €0.98 billion; 3) a €1.14 billion adjustment to goodwill; 4) an adjustment of €0.4 billion to held-to-maturity bonds of Popular. These non-recurring items directly affect the sector's accounts for the half-year, and are the main reason for the losses posted in the period.

- According to the foregoing (Table 2), the system posted losses of €6.18 billion after tax for the half-year (profit of €3.51 billion in the first quarter of the year).

- The first few lines of the P&L account continue to show signs of weakness as in previous quarters, due basically to the interest rate environment. Thus the financial margin fell by 3% for the half-year and net gains on financial transactions and other income were down by 24% relative to the first half of last year. These declines could not be offset by the 9% increase in fee income. The gross margin fell by 7% YoY for the half-year.

- Expenses increased slightly in the first six months of the year due to general expenses (+7% YoY), while personnel costs maintained the downward trend of the past few quarters (-3% YoY for the half-year). General expenses reflect the one-off effect of the restructuring costs of Banco Popular and its integration with Banco Santander. As a result of the lower revenues and increased expenditure, the cost/income ratio deteriorated to 55.5% and the net margin declined by 17% in the first six months of 2017 relative to the same period of 2016.

- The effects of the transaction referred to previously can be seen above all in the lower part of the P&L account, breaking the trend of the previous quarters in which normalisation of provisions and other value adjustments was starting to be habitual. In this regard, bad debt provisions increased by 53% in the half-year, and other results practically tripled due to the combined effect of the factors commented on previously.

1: Throughout the document, "€ billion" refers to thousands of millions of euros.

- The half-year closed with post-tax losses of €6.18 billion (€9.69 billion in 2Q17), as a result of the effects already commented on and the increase in tax paid by the sector in the second quarter, partly due to Banco Popular's non-monetisable tax assets.

Activity

- The deleveraging of the banking system continued (Table 1). The system's total balance sheet shrank by 2.1% to September 2017 and the weight of the banks' balance sheets in GDP stood at 233% at the same date. Furthermore there was a reduction in the number of offices and employees in the system, thus cutting the excess installed capacity (Table 3).

- The total volume of credit to the private sector continues to decline steadily (this is analysed in more detail later). On the liabilities side (Table 1) the volume of debt issued by banks continues to decline, in line with the funding gap (which is at an all-time low) and deposits are holding steady. Thus the more stable retail deposits fell by 1.8% in the twelve months to September (Table 6), although there has been a clear shift from term to sight deposits because of the interest rate environment and the meagre returns on term deposits (Table 8). Liquidity provided by the ECB showed an uptick in 2017 following the TLTRO auctions (up by 30% YoY to October), although remaining well below the peaks of 2012. We do not expect significant increases in this item in the future.

- Lastly, the capital in the balance sheet (Table 1) increases in 2017 (data to September) due to the recapitalisation transactions carried out in the system during the period. The increase is 30% since 2008 (€54 billion).

Spotlight on lending and NPLs

- With data to June 2017 all live lending portfolios continued their downward trend (Table 4), with the exception of non-mortgage lending to households, which was up by 2.7% YoY. The cumulative decline since 2008 in lending to the resident private sector ("Other Resident Sectors", ORS) is 34% or €626 billion, 55% of GDP). The declines continue to be sharper in lending to businesses, especially to those in the construction and real estate sectors (down by 8.4% and 68% respectively YoY since 2008).

- The NPL ratio in the system continues to decline. The total volume of NPLs in the sector stands at €104 billion, showing a 12% decline in the twelve months to September. The reduction from the high point of December 2013 is 46% or €94 billion. The reduction in NPLs is greater in lending to businesses (20% YoY) than in that to households, which shows a slight uptick due to lending to households not secured by mortgage. The unemployment rate stands at 8.33%.

- As for new lending transactions, with data to September 2017 all portfolios show positive variations relative to the YTD volumes for the first nine months of 2016. By portfolio, lending to SMEs and other lending to households show notable increases. At present the annualised volume of new lending is running at 35% of the average for the three years preceding the onset of the crisis.

Main ratios

- The deterioration in the cost/income ratio in the first half of 2017 reflects the effect of the absorption of Banco Popular, as already commented. As a result operating costs as a percentage of Average Total Assets rose above 1% for the first time since 2008 (Figure 6, Appendix 1). Profitability enters negative territory due to the losses of the second quarter of the year (Figure 5, Appendix 1).

- Solvency continues to strengthen. Total capital and reserves in the balance sheet reached 8.9% of total assets (Figure 3, Appendix 1), and the amount of equity in balance sheets more than doubled the amount of non-performing loans in the system, reaching 225% in September 2017 (Figure 2, Appendix 1).

- As regards liquidity, the ratio of ORS lending to ORS deposits fell to 108% as at August, 50 pp less than in 2008 (Figure 3, Appendix 1). The sector's funding gap (ORS lending less ORS deposits) stood at less than 4% of the balance sheet, the minimum level of the series (Figure 4, Appendix 1).

- Provisions increased one-off in the second quarter due to the impact of Banco Popular. The "provisioning effort" (additions to provisions / net margin) and the "cost of risk" (net additions to provisions / average total lending), have increased significantly relative to previous quarters (Figure 1, 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 158 of the main EU banking institutions. The latest data available is from June 2017.

- The Spanish banks have more equity in their balance sheets and better cost/income ratios than their competitors from other European countries (Figure 1, Appendix 2), but their NPL ratio is clearly higher (Figure 2, Appendix 2) despite the continuing fall in the volume of NPLs. Moreover the negative profitability in thje half-year is due to non-recurring issues already commented upon (Figure 4, Appendix 2).

- As for the balance sheet clean-ups, the efforts made in 2012 and 2013 (Figure 3, Appendix 2) were necessary to show the fair value of their assets and to get into line with their European competitors. Thus NPL specific provision coverage has exceeded the European average since the beginning of 2014.

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