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ABBREVIATIONS [(*)]

€	Euro
AIAF	Asociación de Intermediarios de Activos Financieros (Association of Securities Dealers)
ABCP	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
CDO	Collateralised debt obligation
CDS	Credit Default Swap
CEBS	Committee of European Banking Supervisors
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
EBA	European Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
EONIA	Euro overnight index average
EPA	Official Spanish Labour Force Survey
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
FASB	Financial Accounting Standards Board
FROB	Fund for the Orderly Restructuring of the Banking Sector
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSR	Financial Stability Report
FVC	Financial vehicle corporation
GAAP	Generally Accepted Accounting Principles
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
INE	National Statistics Institute
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
LGD	Loss given default
LTROs	Longer-term refinancing operations
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
OMT	Outright Monetary Transactions
OTC	Over the counter

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

PD	Probability of default
PER	Price earnings ratio
pp	Percentage points
RDL	Royal Decree-Law
ROA	Return on assets
ROE	Return on equity
RWA	Risk-weighted assets
SCIs	Specialised credit institutions
SMEs	Small and medium-sized enterprises
SIV	Structured investment vehicle
SPV	Special purpose vehicle
SSM	Single Supervisory Mechanism
TA	Total assets
TARP	Troubled Asset Relief Program
VaR	Value at risk
WTO	World Trade Organisation

CONTENTS

In recent months, European financial markets have seen the continuation of the path of stabilisation initiated in the summer of 2012. Further, the headway in the Single Supervisory Mechanism (SSM), one of the three institutional pillars of the Banking Union, has contributed to easing the notable tension prevalent on the financial markets to July 2012. However, despite this improvement in financial conditions, the situation on the markets has not yet fully returned to normal, and uncertainty and fragmentation remain high.

At the international level, expectations concerning the timing and speed of the withdrawal of the monetary stimuli in the United States have influenced — and will probably continue to do so in the near future — developments on financial markets.

In Spain, where economic activity fell markedly in the final stretch of 2012, the rate of contraction of GDP has progressively eased during the first half of 2013. The latest data show a slight increase in GDP in a setting in which exports continue to be the main underpinning of growth, although there are downside risks in the medium term. Stock market indices have risen in recent months, and the yield spreads on public debt and the credit risk premia on securities issued by the private sector have narrowed. Moreover, the fall-off in the recourse by Spanish banks to Eurosystem liquidity has continued.

The extensive and far-reaching reform of the banking sector continues on track, and is now at an advanced stage. Virtually all the measures contained in the Memorandum of Understanding (MoU) have now been implemented. The objectives are being met on schedule and the measures are being applied correctly, as reflected in the preliminary conclusions published in late September by the European Commission (EC), the ECB and the International Monetary Fund (IMF) following its recent visit to monitor the programme of financial assistance to the Spanish banking sector. As a result of these measures, capital, liquidity and efficiency levels of the financial system have been bolstered, as has the framework of governance, regulation and supervision of the Spanish banking sector. Further, the statements by the EC, ECB and IMF assess favourably the development by the Banco de España of a tool to regularly conduct forward-looking analyses of Spanish banks under different scenarios.

The banking sector has pursued its business in recent months in a setting marked by the easing of tensions on European financial markets, by the weakness of the real economy and by its own ongoing restructuring and recapitalisation process. Furthermore, the correction of the excessive debt of households and firms — one of the main imbalances in our economy — has continued. Against this background, business lending to the resident private sector in Spain has continued to fall, although in recent months the path of decline observed since 2011 has moderated. The decline can be seen practically across the board for the different institutional sectors and sectors of activity. In terms of banks' exposure, the decline is also generalised, although it is less marked for those banks not subject to restructuring plans.

The doubtful assets of the private sector have continued to increase, except in construction and real estate development, although the decline in these sectors is principally due to the transfer of assets to Sareb. As a result of the review of the accounting classification of refinanced and restructured portfolios which the Banco de España requested of banks, there is likely to be an upward revision of doubtful assets, whose impact on results can, it is estimated, be borne by banks. The doubtful loans ratio for credit to the resident private sector has continued to grow in a relatively generalised way across households and non-financial corporations. However, the downward dynamic of lending has progressively gained in relative importance as an explanatory factor of the rise in the doubtful loans ratio over the past year.

The improved funding conditions on wholesale financial markets in recent months have been manifest in the fall in the systemic risk indicators for Spain, and in the significant reduction in the gross recourse to the Eurosystem by Spanish banks. Since autumn 2012, the deposits of households and non-financial corporations have increased, posting increasingly higher year-on-year rates of change. The growth in 2013 of bank deposits, along with the gradual deleveraging by households and firms, is prompting a progressive correction of the Spanish banking sector's retail funding gap.

Following its heavy losses in 2012, the Spanish banking sector as a whole posted positive results in the first half of 2013. The improvement is due chiefly to the lower provisioning by banks following the extraordinary drive last year in the wake of the asset value adjustments relating to real estate development activity. Margins are subject to pressures derived from the weak economic climate, which affects the volume of business and that of non-performing loans, in a setting of low interest rates. This situation should lead banks to persevere with their policies to cut operating costs and achieve gains in efficiency.

Capital levels have recently risen appreciably for Spanish banks as a whole, owing to both the ongoing recapitalisation of the Group 1 and 2 banks, and the improvement shown by other banks over the past year. Despite improved solvency ratios, banks must continue striving to strengthen their regulatory capital, which is what lay behind the recommendation issued last June concerning dividend distribution policy.

Chapter 3 of this FSR presents for the first time the progress made by the Banco de España in developing a tool which enables forward-looking analyses to be made to assess the sensitivity of Spanish banks' solvency to different macroeconomic scenarios, and which will be part of the supervisor's toolkit. The tool will be subject to a process of continuous refinements over time so that best practices in the field may be incorporated and, in turn, so that the needs of the supervisor may be met. The initial results available, which are set out in Chapter 3, show that the set of institutions analysed are in a comfortable position in terms of solvency under the three macroeconomic scenarios considered.

In sum, the reform, restructuring and recapitalisation of the Spanish banking sector has continued to make headway in 2013 following the course envisaged in the MoU. The achievements in terms of banks' solvency and liquidity, and of the regulation and supervision of the sector, have contributed — along with the continuous easing of tensions on international financial markets — to increasing confidence and improving market sentiment as regards Spanish banks. The market perception of the situation of Spanish banks, judging by the substantial improvement in their share prices and in their price-to-book value, has trended very favourably throughout the year. However, the still-fragile situation of the Spanish economy, the incomplete normalisation of euro area financial markets and the subsequent pressures on banks' income statements will oblige banks to make additional cost-containment and capital-preservation efforts. In any event, the creation in the coming months of the SSM following the recent approval of the related

Community regulation, as a first step for setting up the Banking Union, marks a milestone in overcoming the imperfections identified during the crisis in the functioning of the Monetary Union. At the same time, it poses a major challenge for the Spanish and European banking system in terms of adaptation.

Developments on financial markets have been partly influenced by expectations concerning the withdrawal of the monetary stimuli in the United States. In the euro area, the expansionary monetary policy stance was maintained. Other conditioning factors of market developments have been the uncertainty over Syria, the more favourable macro data in some advanced countries and the progress on Banking Union in Europe.

In recent months developments on international financial markets have been partly influenced by the expectations concerning the speed of withdrawal of the monetary stimuli in the United States, once the Federal Reserve announced in May the possibility that it would shortly begin gradually to reduce its asset purchases. By contrast, in the euro area the ECB has maintained its expansionary monetary policy stance, which has been bolstered by the 25 bp cut in official interest rates in May and by the announcement, in early July, that it would keep these rates at their current or lower levels for a prolonged period. In addition, it has stated it will maintain its fixed-rate tender procedures with full allotment at least until mid-2014. Other significant conditioning factors of recent developments on international financial markets have been the uncertainty over the problems in Syria, the release of more-favourable-than-expected macroeconomic data in some advanced economies and the progress on Banking Union in Europe, and, in particular, the approval by the European Parliament in September of the regulation providing for the start-up of the Single Supervisory Mechanism.

Long-term interest rates have risen in the United States and in Germany. In Spain, government bond yield spreads have narrowed as have the credit risk premia on securities issued by the private sector, stock market indices have risen and banks' recourse to the Eurosystem has continued to lessen.

Against this background, the long-term yields on US debt have risen, passing through to the economies with a higher credit rating such as the United Kingdom and Germany, and prompting one-off increases in the volatility of traded prices (see Chart 1.1). In the European countries most affected by financial tensions, long-term sovereign debt yields have fallen somewhat or have risen, in general, to a lesser extent, with yield spreads narrowing. In the case of Spanish 10-year bonds, the spread over the German benchmark narrowed from levels close to 300 bp in late April to around 235 bp in late October. The credit risk premia on fixed-income securities issued by resident financial and non-financial corporations have also tended to lessen. This improvement in wholesale market funding conditions has been further reflected in the fall-off in Spanish banks' recourse to Eurosystem liquidity. On the Spanish stock markets, the Ibex 35 has climbed 16% in the past three months, a gain above the rises in other developed countries' market indices, such as the S&P 500 or the Euro Stoxx 50.

In the emerging economies, financial market conditions have trended adversely.

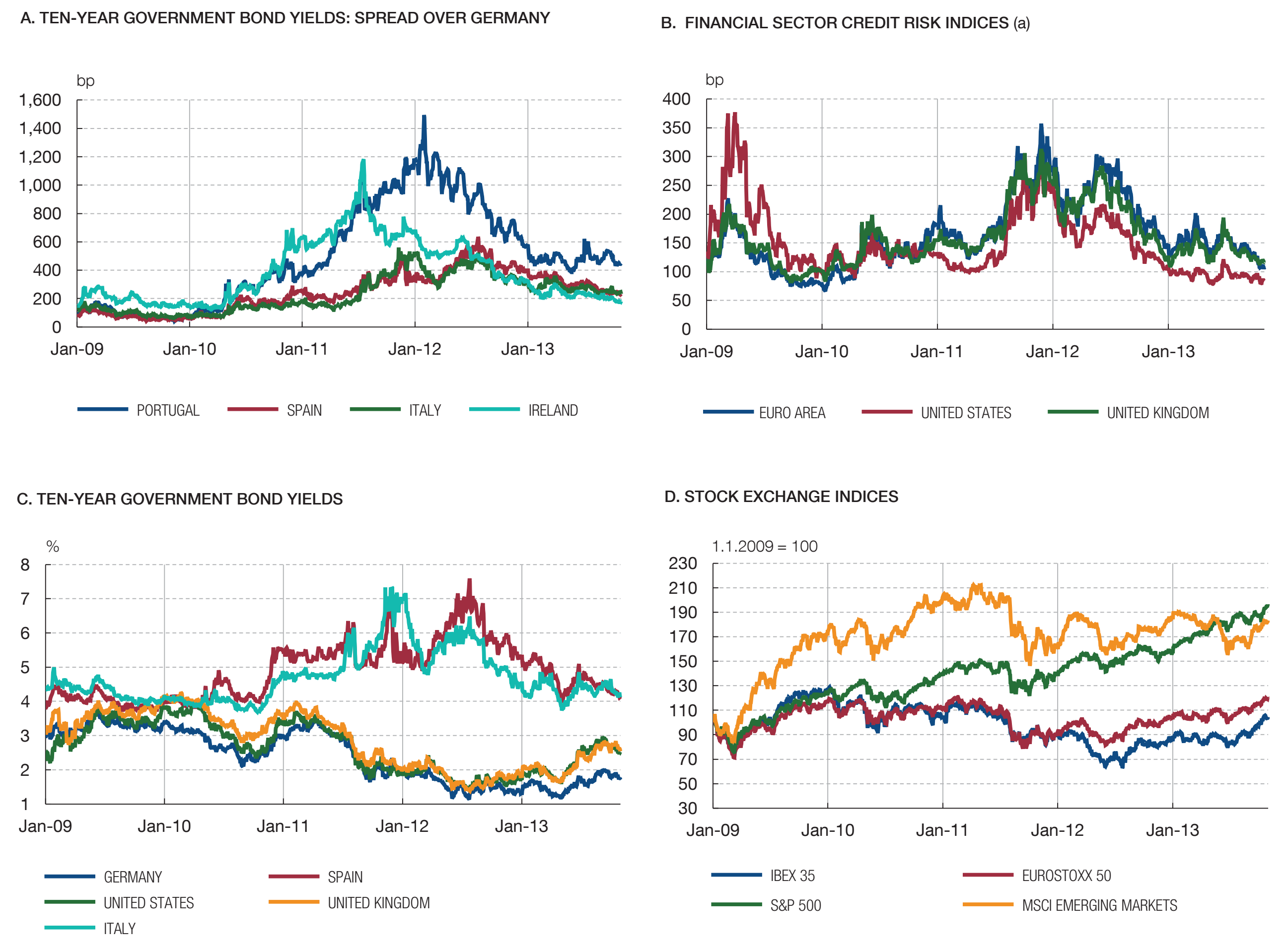
The emerging economies were particularly vulnerable to the global financial climate, and conditions on their markets trended unfavourably, acutely so when market expectations of a diminished monetary stimulus in the United States stepped up, although the situation differed from one country to another. Specifically, there have been heavy capital outflows associated with currency depreciations, declines in stock market prices and a widening of sovereign spreads, as well as bonds issues grinding to a halt in the summer months. There was a turnaround in this pattern in early September, in step with the subsequently confirmed prospect of the Federal Reserve purchases programme being maintained.

The emerging economies are losing momentum while there is confirmation of an incipient recovery in some advanced economies outside the euro area.

The macroeconomic data of recent months show some restructuring of global growth, whereby the emerging economies are losing momentum, though they continue to grow at higher rates than the advanced economies; at the same time, the incipient recovery in some of the developed countries appears to be firming. Indeed, in the main advanced economies outside the euro area, the improvement they had experienced in 2013 Q1 was confirmed in Q2, overcoming the weakness shown in the final stretch of the previous year. The indicators available for Q3 suggest these trends will continue, although the recovery remains fragile and the balance of risks remains on the downside. In the short run the prominent risks are those linked to the fiscal problems in the United States, the associated

PRICES NEGOTIATED ON FINANCIAL MARKETS

CHART 1.1



SOURCES: Datastream, Reuters and Bloomberg.

a Euro area: 5-year iTraxx Europe Senior Financials. United States and United Kingdom: average 5-year CDS for commercial banks. Latest data: 30 October 2013.

future tightening of financial conditions, the start of the US monetary normalisation, the steepening of the slowdown in the emerging countries and the heightening of tensions in the Middle East.

Euro area GDP grew once again in Q2 after six consecutive quarters of declines; but the medium-term outlook remains one of slow recovery, with downside risks.

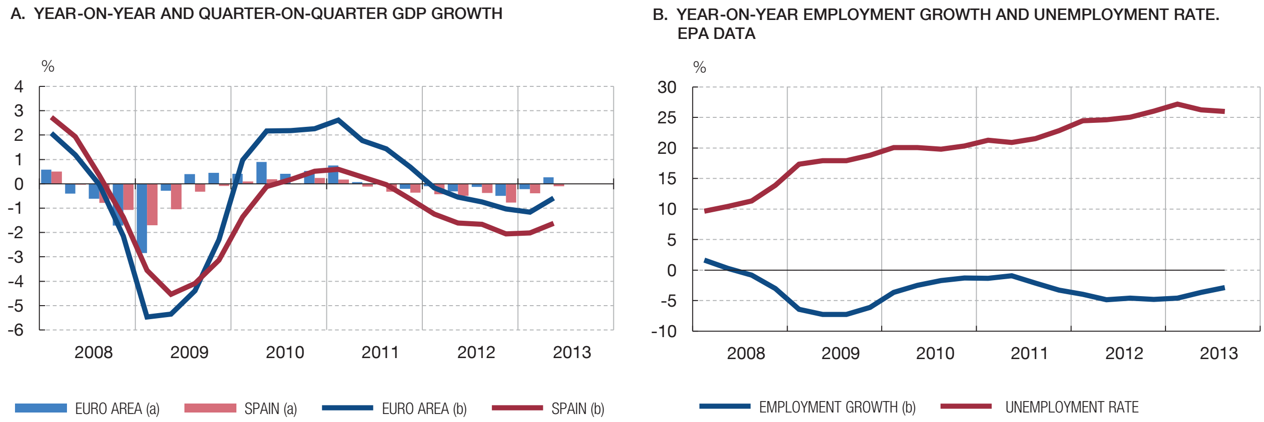
In the euro area in 2013 Q2, GDP posted a quarter-on-quarter increase of 0.3%, following six consecutive quarters of declines (see Chart 1.2.A). However, this rebound is partly due to transitory factors, meaning that the medium-term growth outlook remains one of slow and gradual recovery, with downside risks. Against this background, the ECB's September projection exercise, in comparison with that in June, revised GDP growth forecasts for 2013 up 0.2 pp to -0.4%, while those for 2014 were cut by 0.1 pp to 1%.

In Spain, the contraction in GDP eased in Q2 and increased slightly in Q3, checking the pace of job destruction.

In Spain, GDP posted a quarter-on-quarter decline of 0.1% in Q2, compared with the fall of 0.4% in the previous quarter. The INE flash estimate for Q3 shows a year-on-year increase in GDP of 0.1%. The more favourable economic performance was also perceptible in a decline in the pace of job destruction, which stood in the same period, according to the Spanish Labour Force Survey (EPA), at 2.9%, against 4.6% in March (see Chart 1.2.B). The unemployment rate dipped slightly from April to September, assisted by the less negative trend of employment and by seasonal factors, but it remains at very high levels close to 26%.

GDP AND EMPLOYMENT

CHART 1.2



SOURCES: INE, Eurostat and Banco de España.

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

The deleveraging of households and firms, which remain subject to a high degree of financial pressure, continues, …

In parallel, household and corporate debt has continued to shrink, although the unfavourable behaviour of income has continued to restrict the fall in debt ratios, which remain at higher levels than the euro area average. According to the latest information from the Central Balance Sheet Data Office, the ordinary net profit of the reporting corporations fell by 14.9% year-on-year on the first half of 2013, which has made for a further fall-off in profitability. In the case of households, the difficulties arising from high unemployment rates and the adverse trend of income have been compounded by the decline in net wealth, essentially as a result of the fall in house prices, which has continued in recent months. These developments shape a scenario of high financial pressure in the households and non-financial corporations sector.

… as does the marked momentum of general government debt.

In the case of general government, the year-on-year increase in debt stood, in August, at around 18%, while the latest figures on the debt ratio, for 2013 Q2, place it at 92.3% of GDP.

Financial conditions have not fully normalised and the risks linked to economic developments remain considerable

In sum, since the publication of the last FSR, the pattern of improvement in financing conditions for the resident sectors on wholesale markets has continued, although these markets have not yet fully normalised. The latest data show a slight increase in GDP in Spain, although in the medium term there are downside risks.

2.1 Banking risks

2.1.1 Consolidated balance sheet of deposit institutions

Deposit institutions' total consolidated assets decreased by 6.7% in June 2013

Total consolidated **assets** of deposit institutions, which include their business in Spain and that of their subsidiaries abroad, reached €3,747 billion in June 2013, showing a negative year-on-year rate of change of 6.7% (see Table 2.1). The decline in total assets was broad-based across institutions, although it was sharper for the so-called Group 1 and 2 banks.[1] These groups of institutions accounted for 71% of the year-on-year reduction in consolidated assets since their assets fell 11.9% in June 2013, while the decrease for other deposit institutions was 5.7%.

The decrease in financing to the private sector was sharper for banks which transferred assets to Sareb

Financing to the private sector, which includes credit and fixed income, declined by 8.1% in the last year (see memorandum item of Table 2.1), decreasing its weight in the balance sheet to 60.6% in June 2013 (61.5% in the previous year). Financing to the private sector fell as a consequence of the year-on-year reduction in credit to the private sector which decreased by 11% in June 2013; its relative weight in the balance sheet declined from 58.8% in June 2012 to 56.1% in June 2013 (see Table 2.1). This behaviour was affected by the transfer of assets of Group 1 and 2 banks to Sareb. Thus, while the fall in credit was broad-based across institutions, it was notably sharper for Group 1 and 2 banks, which account for 6.3 pp of the 11% fall in credit for the sector as a whole, although the weight of these banks in total deposit institutions was 13.7% in June 2013 in terms of credit to the private sector.

The trend in fixed income to the private sector was the opposite to that of credit and in June 2013 it grew by 53.6% year-on-year. This increase partly reflects the subscription by the FROB of ordinary shares of institutions recapitalised through the contribution of securities issued by the ESM. It also shows the transfer of assets to Sareb since the Group 1 and 2 banks received State-guaranteed senior bonds in consideration for the transferred assets from Sareb.

Financing to general government increased due to the trend in fixed income

Financing to general government (credit and fixed income) increased by 7.6% year-on-year in June 2013. Also, in this case credit and fixed income performed differently. While credit fell at a rate of 13.7% in year-on-year terms, fixed income grew by 17.2% in the same period, partly owing to the conversion into securities of a portion of the loan for the financing of suppliers. The weight of financing to general government in the consolidated balance sheet increased over the last year from 11.8% in June 2012 to 13.5% in June 2013 (see memorandum item of Table 2.1).

The rate of increase of doubtful assets moderated, which is partly explained by the transfer of assets to Sareb

Total doubtful assets at the consolidated balance sheet level grew by 5.1% year-on-year in June 2013, a more moderate rate than that observed in December 2012 (18.9% year-on-year) and that in June 2012 (34.5%). As described in greater detail below, when analysing changes in doubtful assets in credit to the private sector in business in Spain, the moderation

1 Groups 1 and 2 comprise those institutions which needed State aid to recapitalise and which transferred their real estate assets to Sareb (the asset management company for assets arising from bank restructuring) in December 2012 and in February 2013, respectively, as agreed in the Memorandum of Understanding (MoU) for financial assistance to Spanish banks and the parameters defined in the restructuring plans approved by the European Commission on 28 November 2012 for Group 1 banks and on 20 December 2012 for Group 2 banks. The effects of these asset transfers make it difficult to compare on a year-on-year basis some of the data presented in this report.

CONSOLIDATED BALANCE SHEET.
DEPOSIT INSTITUTIONS

TABLE 2.1

Assets	Jun-13	Change Jun-13/ Jun-12	Relative Weight Jun-12	Relative Weight Jun-13
	(€m)	(%)	(%)	(%)
Cash and balances with central banks	129,483	-11.4	3.6	3.5
Loans and advances to credit institutions	238,932	4.9	5.7	6.4
General government	107,859	-13.7	3.1	2.9
Other private sectors	2,100,522	-11.0	58.8	56.1
Debt securities	643,395	19.0	13.5	17.2
Other equity instruments	35,825	-4.3	0.9	1.0
Investments	53,680	-4.2	1.4	1.4
Derivatives	213,403	-19.9	6.6	5.7
Tangible assets	47,897	-4.2	1.2	1.3
Other (a)	175,684	-14.6	5.1	4.7
TOTAL ASSETS	**3,746,680**	**-6.7**	**100**	**100**
MEMORANDUM ITEMS				
Financing to private sector	2,270,646	-8.1	61.5	60.6
Financing to general government	507,520	7.6	11.8	13.5
Total doubtful assets	204,121	5.1	4.8	5.4
Total doubtful assets ratio	6.6	63 (c)		
Provisions for bad debts and country risk	126,802	6.6	3.0	3.4

Liabilities and equity	Jun-13	Change Jun-13/ Jun-12	Relative Weight Jun-12	Relative Weight Jun-13
	(€m)	(%)	(%)	(%)
Balances from central banks	272,483	-33.8	10.3	7.3
Deposits from credit institutions	444,504	-4.6	11.6	11.9
General government	111,061	16.3	2.4	3.0
Other private sectors	1,755,035	0.5	43.5	46.8
Marketable debt securities	447,167	-11.9	12.6	11.9
Derivatives	194,976	-19.6	6.0	5.2
Subordinated debt	42,214	-42.1	1.8	1.1
Provisions for pensions, tax and other	37,564	13.2	0.8	1.0
Other (a)	211,815	-4.9	5.5	5.7
TOTAL LIABILITIES	**3,516,817**	**-7.4**	**94.6**	**93.9**
MEMORANDUM ITEMS				
Eurosystem net lending (b)	241,089		9.4	6.4
Minority interests	25,909	9.7	0.6	0.7
Valuation adjustments relating to total equity	-16,362	.	-0.4	-0.4
Own funds	220,317	4.9	5.2	5.9
TOTAL EQUITY	**229,863**	**6.3**	**5.4**	**6.1**
TOTAL LIABILITIES AND EQUITY	**3,746,680**	**-6.7**	**100**	**100**

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. September 2013 data (latest available) and September 2012 data to maintain the year-on-year comparison.
c Difference calculated in bp.

in the rate of increase in doubtful assets is explained to a large degree by the transfers of real estate loans – part of which were classified as doubtful – to Sareb by Group 1 and 2 banks and, to a lesser degree by a slight moderation in the growth rate of doubtful assets for other institutions. In any event, the reduction in credit to the private sector and the increase in doubtful assets led to a rise in the overall doubtful assets ratio[2] in the consolidated balance sheet of deposit institutions as a whole, from 6% in June 2012 to 6.6% in June 2013. Provisions for bad debts and country risk increased in the last year (with a year-on-year rate of change of 6.6% in June 2013; see memorandum item of Table 2.1).

Tangible assets declined, in year-on-year terms, by 4.2% (see Table 2.1), which is explained by the reduction in tangible assets for own use, against a backdrop of a decrease in the number of offices and of a readjustment of overhead costs by the Spanish banking sector.

The assets heading "Other" includes all those consolidated balance sheet items that are not explicitly shown in Table 2.1, including the amount of impairment allowances (mostly provisions for bad debts and country risk). Accordingly, this residual heading is made up of positive and negative elements (the above-mentioned impairment allowances). Its decline in June 2013 (14.6% year-on-year, see Table 2.1), is largely explained by the above-mentioned increase in provisions for bad debts and country risk.

Net lending from the Eurosystem declined over the last year

Notable on the **liabilities** side was the decline posted in balances of central banks, which fell by 33.8% year-on-year in June 2013. This decline contrasted with the sharp increase recorded between June 2011 and June 2012. This was due to the operations of institutions with the Eurosystem. The latter provided long-term liquidity to institutions in the euro area owing to the tensions and dysfunctions in financial markets. These operations with the Eurosystem decreased notably during the last year and have continued to do so gradually both as a result of the improvement in financial markets and the recovery seen in non-financial firms' and households' deposits.

Private-sector deposits reversed the trend of slight contraction that had been observed since mid-2012 to show positive year-on-year rates of change from the beginning of this year

Private-sector deposits grew at a year-on-year rate of 0.5% to June 2013 (see Table 2.1), compared with the decrease of 4% observed one year earlier. Given the decrease in assets, the relative weight of these deposits grew from 43.5% to 46.8% in the last year. More importantly, and as analysed subsequently in detail, the improvement, in terms of financing through private-sector deposits, is especially discernible when examining the deposits of non-financial firms and households, which reflect the retail financing of deposit institutions and which have reversed the trend of slight contraction that had been observed since mid-2012, by starting to show slightly positive year-on-year rates of change since the beginning of the year.

The total equity of deposit institutions grew at a year-on-year rate of 6.3% in June 2013, increasing its weight in total assets to 6.1% compared with 5.4% a year earlier (see Table 2.1). This increase was largely due to changes in institutions' own funds which grew by 4.9% to reach 5.9% of total consolidated assets.

2.1.2 Credit to and doubtful assets of the resident private sector in business in Spain (ID)

Credit to the resident private sector in business in Spain decreased in June 2013,…

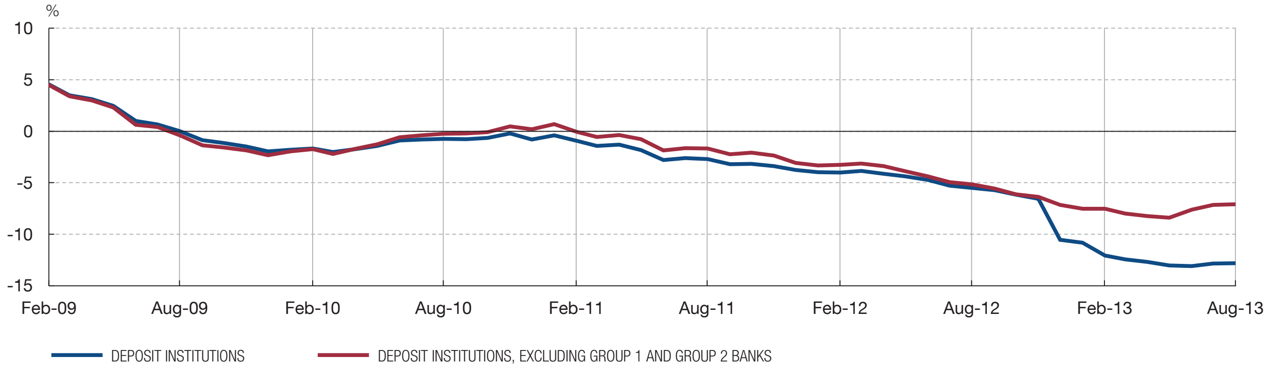
The year-on-year rate of change of **credit to the resident private sector in business in Spain,** according to individual financial statement data, was –12.8% in August 2013, which is the latest available data (see Chart 2.1.A). The severity of the decline in credit and the most recent trend have been compounded largely as a result first, of the transfer of property development loans of Groups 1 and 2 to Sareb in December 2012 and in February 2013, respectively; and further, of the deleveraging processes commenced by these banks due to their restructuring plans. Excluding Group 1 and Group 2 banks from total institutions

2 For the purposes of this Report the "ratio de morosidad" and the "ratio de dudosos" are considered to be equivalent concepts (both are translated as "doubtful assets ratio"). In both cases they include assets that are doubtful by reason of being past-due (by more than 90 days) along with other transactions that are classified as doubtful even though they are not 90 days past-due.

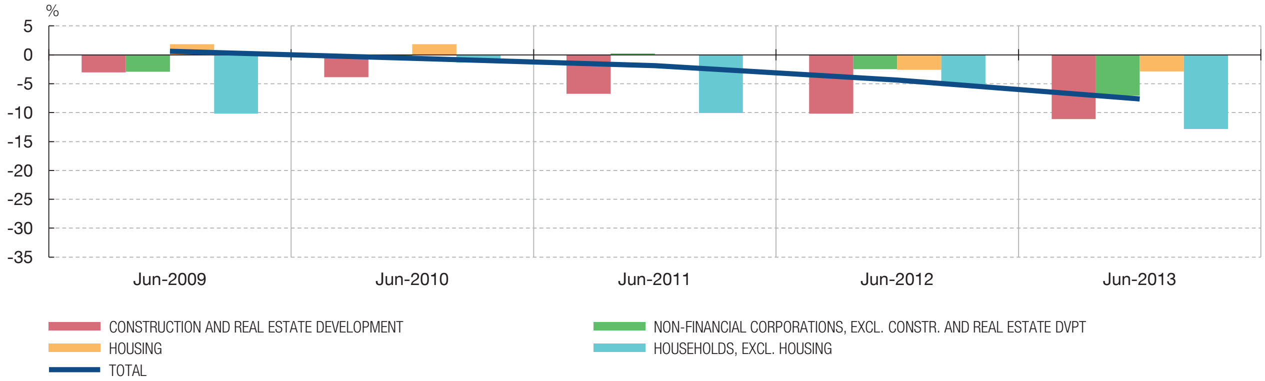
CREDIT TO THE RESIDENT PRIVATE SECTOR
Business in Spain, ID

CHART 2.1

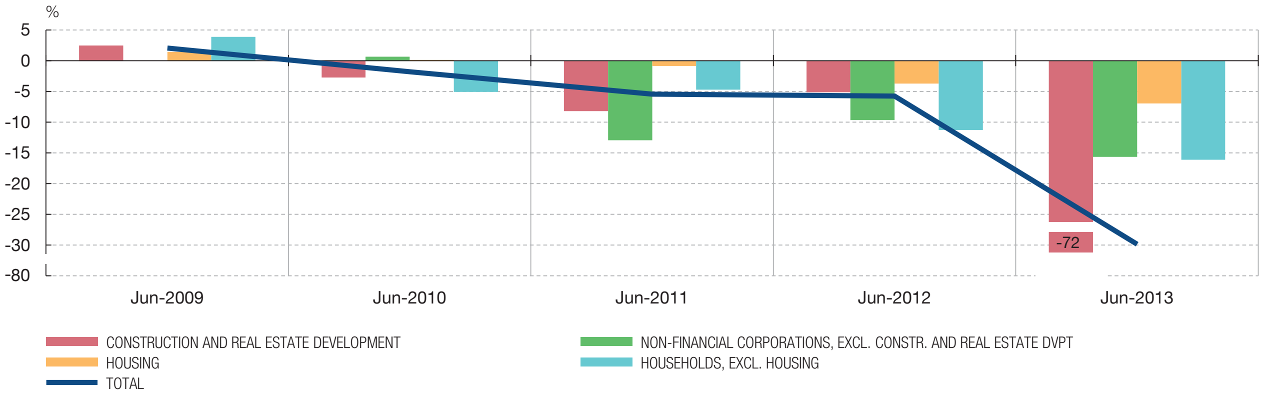
A. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR



B. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR BY SECTOR OF ACTIVITY
DEPOSIT INSTITUTIONS, EXCLUDING GROUP 1 AND GROUP 2 BANKS



C. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR BY SECTOR OF ACTIVITY
GROUP 1 AND GROUP 2 BANKS



SOURCE: Banco de España.

(see Chart 2.1.A) it can be observed that credit fell less sharply during 2013. From Q2 the rate of change, albeit still negative, was somewhat more moderate.

…both in terms of credit to individuals…

The latest available data which breakdown credit by institutional sector and sectors of activity (relating to June 2013) show a fall in credit to individuals of 5.6% year-on-year compared with a fall of 3.6% in June 2012. This performance was the same for Group 1 and 2 banks and for the other institutions, although the decline has been more severe and has accelerated more in the last year for Group 1 and 2 banks (see Charts 2.1.B and C).

Within credit to individuals, sharper rates of decline were observed in credit for purposes other than house purchase (–13.5% year-on-year in June 2013), a situation which is the same for Groups 1 and 2 and for the other institutions as a whole, whereas the rates of decline are steeper for Groups 1 and 2 (see Charts 2.1.B and C).

… and to non-financial firms, where the reduction of credit is concentrated in the construction and real estate activities sector.

The reduction of credit to non-financial firms is concentrated in the construction and real estate activities sector, which for the institutions as a whole contracted at a year-on-year rate of 30.8% in June 2013, compared with a decline of credit in other business activities of 8.5% as of the same date. Credit to the construction and real estate development sector concentrates the effect of the transfer of assets to Sareb by Group 1 and 2 banks which explains negative rates of change of 72% for these groups of banks, that are significantly higher than for other deposit institutions (see Charts 2.1.B and C)

As indicated, for other business activities, that is excluding construction and real estate development, the rate of change of credit was also negative (–8.5% in June 2013), but less markedly so. In any event, there was also a higher fall in credit in other business sectors in June 2013 than a year earlier (–3.8%), which was relatively broad-based (see Chart 2.2.A). In terms of the respective groups of institutions, the conclusions are similar to those mentioned above for total credit, namely that for all institutions the reduction of credit continues, but both the pace and strength of the decline over the last year are greater for the banks in Groups 1 and 2.

The reduction of credit is also seen at non-financial corporations of various sizes, although rates of decline stabilised somewhat, except for the larger firms which have resorted to a greater extent to financing in the financial markets

The size of non-financial corporations can be approximated[3] by the volume of bank debt reported to the CCR. On the basis of this approximation and focusing the analysis on the group of non-financial firms not engaging in construction and real estate development activities, the fall in credit is broad-based. Nevertheless, it can be seen that, except for the larger firms, for the others the rate of decline has tended to stabilise over recent months (see Chart 2.2.B). Larger non-financial firms, against a backdrop of improving conditions in financial markets, have been able to issue debt which may help to explain the developments observed in bank credit (see Chart 2.2.C).

In short, the latest data available on changes in credit reflect a relatively broad-based decline for the different borrowers and sectors of activity. Within this general trend, differences persist both in the business sectors – most notably the fall of credit to construction and real estate development activities – and among banks. Those banks not transferring assets to Sareb show more moderate (albeit still negative) rates of change in relation to the rates of Group 1 and 2 banks, which are implementing asset reduction processes as required in their restructuring plans.[4]

The fall in credit, which has moderated in recent months, is in response to the difficult economic situation and to the correction of excessive debt built up during the economic boom. In addition to this are other factors such as that related to fragmentation problems still existing in the euro area, which mean higher financing costs for Spanish institutions than those which would arise from an expansionary stance of the single monetary policy; and lenders' poorer perception of customers' creditworthiness in the current economic setting.

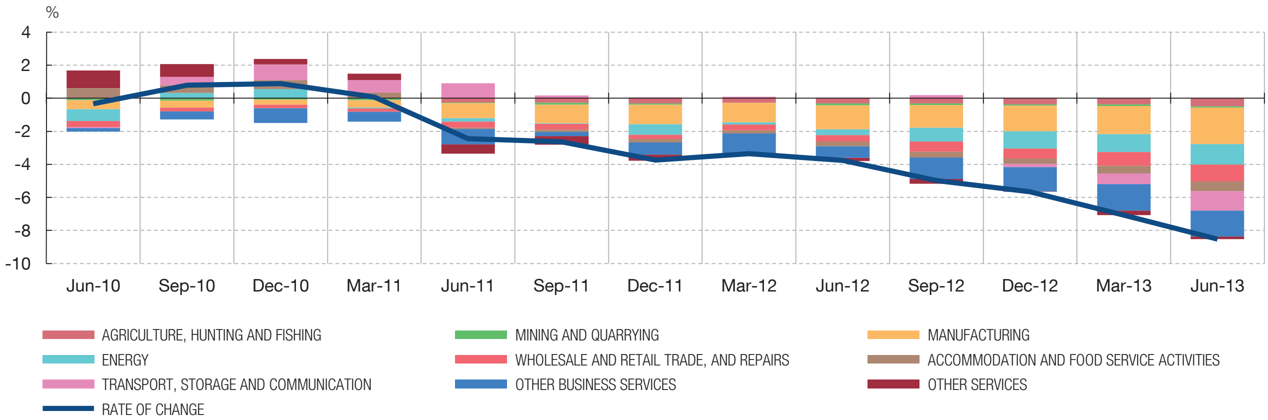
3 Circular 4/2013 of 27 September 2013 modifies the definition of SME in Banco de España Circular 3/2008 on the determination and control of minimum regulatory capital. Its entry into force, following its publication in the Official State Gazette of 12 October 2013, will facilitate compiling information to identify credit to SMEs.

4 Foreseeably, a substantial part of the fall due to this will be absorbed by other institutions not subject to restrictions. See Box 6.1 of the Banco de España's Annual Report 2012.

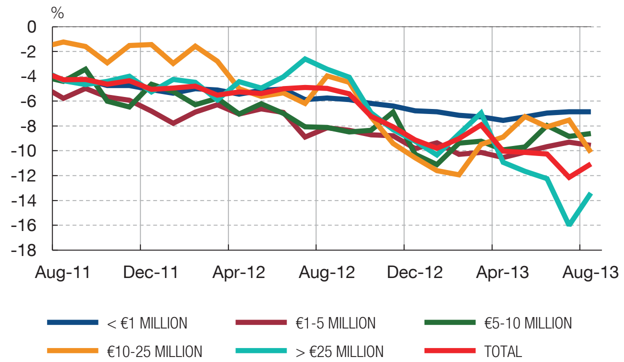
CREDIT TO THE RESIDENT PRIVATE SECTOR
Business in Spain, ID. Deposit institutions

CHART 2.2

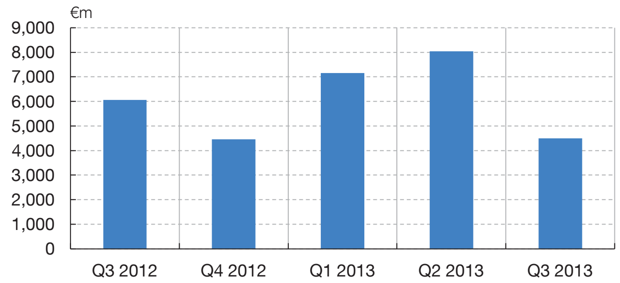
A. CONTRIBUTIONS TO THE YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR OF SECTORS OF ACTIVITY OTHER THAN CONSTRUCTION AND REAL ESTATE DEVELOPMENT



B. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO NON-FINANCIAL CORPORATIONS, OTHER THAN CONSTRUCTION AND REAL ESTATE DEVELOPMENT, BY SIZE OF CORPORATION (a)



C. MAIN ISSUES OF SPANISH NON-FINANCIAL CORPORATIONS IN MEDIUM-AND LONG-TERM WHOLESALE MARKETS



SOURCES: Central Credit Register (CCR), Banco de España and Dealogic.

a Corporation size is proxied by the volume of bank debt reported to the Banco de España Central Credit Register.

Doubtful assets continued to increase albeit at a more moderate rate

The **doubtful assets** of credit to the resident private sector in business in Spain, according to individual financial statement data, grew at a year-on-year rate of 4.4% in June 2013, compared with 39.4% a year earlier (see Chart 2.3.A). The latest available data confirm the stabilisation in the rate of increase of doubtful assets, which in August 2013 recorded year-on-year growth of 0.7% (41.1% in the same month of 2012).

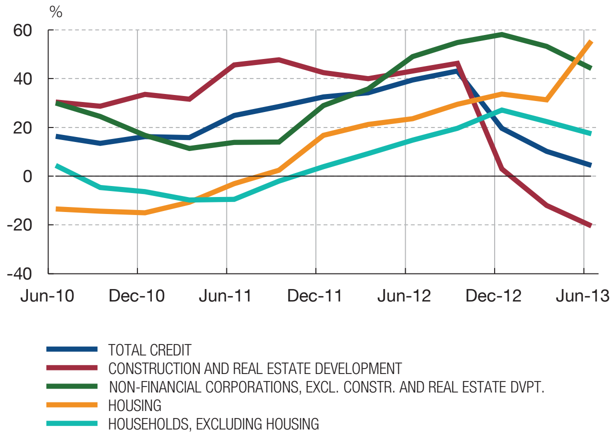
The robust moderation of doubtful assets is explained by the transfer of assets to Sareb by Group 1 and 2 banks, while the rate of increase for other institutions held at similar levels to those of the previous year

The sharp moderation in the rate of increase of doubtful assets is explained by the performance of doubtful assets related to construction and real estate development activities, which in June 2013 (the latest available data with this sectorisation, since their frequency is quarterly) recorded a year-on-year fall of 20.5%. The decrease of doubtful assets related to the construction and real estate development sector is explained by the transfer of assets to Sareb by Group 1 and 2 banks, whose volume of doubtful assets associated with this sector thus decreased by 72.5% in June 2013 in relation to the same period of 2012. The transfer to Sareb explains that for Group 1 and 2 banks doubtful assets of credit to the private sector in business in Spain declined at a year-on-year rate of 31.8% in June 2013, while for other institutions they increased as of the same date by 24.7%, a slightly lower growth rate than a year earlier (26.3%).

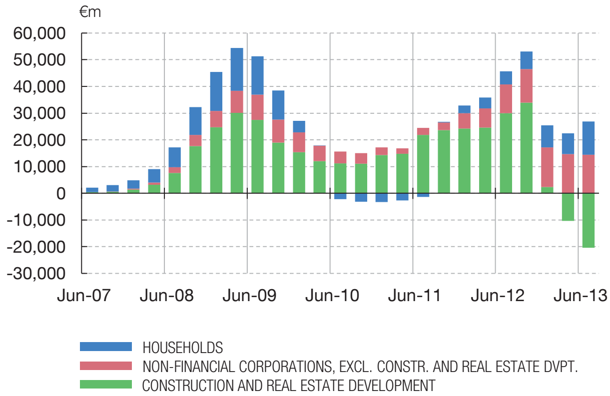
DOUBTFUL ASSETS. RESIDENT PRIVATE SECTOR.
Business in Spain, ID. Deposit institutions

CHART 2.3

A. YEAR-ON-YEAR RATE OF CHANGE IN DOUBTFUL ASSETS



B. YEAR-ON-YEAR CHANGE IN DOUBTFUL ASSETS



SOURCE: Banco de España.

For other business sectors and individuals, the rate of increase of doubtful assets has continued,…

Doubtful assets have continued to rise for other business sectors and for individuals. This is perceptible both for Group 1 and 2 banks and other banks. Thus, for individuals, doubtful assets grew year-on-year by 43.2% in June 2013. This performance of doubtful assets in credit to households can be seen in credit for house purchase and, slightly less markedly, in credit for other purposes (see Charts 2.3 A and B). Doubtful assets of firms other than construction and real-estate development increased by 44.2% in June 2013, a similar rate for all banks.

… and it will be pushed higher to some degree by the accounting review of refinanced portfolios requested by the Banco de España of institutions

The most recent data on growth of doubtful assets must be assessed in the light of the review of the accounting classification of refinanced or restructured portfolios. The Banco de España requested institutions to perform this work in order to ensure the uniformity of the criteria to be applied to refinancing and restructuring which were published last April.[5] Institutions were requested to report the corresponding accounting effects to the Banco de España's Inspection Department before 30 September. However, the institutions' rate of progress has been varied and some have been able to advance these effects to a certain extent. These one-off effects will affect developments in doubtful assets and the doubtful assets ratios over coming months, insofar as this review will give rise to standard or substandard restructured loans being reclassified as doubtful (see Box 2.1).

The doubtful assets ratio of the resident private sector increased in the first half of 2013

The **doubtful assets ratio** of credit to the resident private sector in business in Spain reached 11.9% in June 2013, higher than the figure of 10% recorded a year earlier. The most recent data for August 2013, stood at 12.5%.

These developments in the doubtful assets ratio have been conditioned by several factors, including the transfer of real estate assets to Sareb. Consequently, the doubtful assets ratio for institutions which did not transfer assets amounted to 11.9% in August 2013, compared with 9.1% a year earlier; whereas Group 1 and 2 banks reduced their ratio from 15.9% (17.9% in November 2012, one month prior to the transfer of assets of Group 1 banks to Sareb) to 14.9%.

5 http://www.bde.es/f/webbde/COM/Supervision/regulacion/ficheros/en/documentoCE300413_en.pdf (See Box 2.1)

Banco de España Circular (CBE) 6/2012 of 28 December 2012, which amends CBE 4/2004, requires institutions to disclose in their annual accounts specific information relating to refinancing and restructuring transactions (amounts; classification as standard, sub-standard or doubtful exposures; coverage; and breakdown by purpose of the financing). Also, it introduces a precise definition of this type of transaction, which is already envisaged in CBE 4/2004 as a factor to consider in the assessment of possible loan impairment.

In accordance with CBE 6/2012, a refinancing transaction is defined as one that is granted for economic or legal reasons relating to (current or foreseeable) financial difficulties of the borrower to repay one or more transactions already granted, or under which the payments on such transactions are brought totally or partially up to date, in order to enable borrowers under repaid or refinanced transactions to pay their debt (principal and interest) because they are unable, or it is foreseeable that they will be unable, to comply in time and in form with its conditions. A restructuring transaction[1] is defined in a similar manner to a refinancing transaction but refers to the modification of the financial conditions of the transaction in order to facilitate payment of the debt. Circular 6/2012 distinguishes these refinancing and restructuring transactions from others, with specific features, such as rolled-over or renegotiated transactions.

The data reported by the institutions pursuant to CBE 6/2012 presented, in the Banco de España's opinion, differences between institutions which might be driven by diverse business and management profiles but also by discrepancies in the accounting policies used. For this reason, the Banco de España decided to develop a set of criteria that institutions must take into account in preparing and approving their refinancing policies and in the accounting classification of the transactions affected. These criteria are not a new regulation on this subject but a reference which institutions must follow so as to adequately comply with CBE 4/2004. The objective is to ensure consistent and uniform application of the rules throughout the banking industry so that reporting differences between institutions are only caused by different business and management models and not by divergent interpretations of the same accounting rules.

The criteria on refinancing and restructuring mainly envisage aspects such as determining the borrowers' ability to pay and the up-to-date valuation of the collateral provided and, furthermore, other factors such as the grace period of transactions. In accordance with the provisions of Annex IX of CBE 4/2004 and the above-mentioned criteria, transactions shall be classified as sub-standard, provided that there are no objective circumstances for them to be classified as doubtful or standard risks.

When the criteria on refinancing and restructuring were published, the Banco de España urged institutions to review, through a study on an individual basis of their transactions, the accounting classification of refinanced portfolios and the related accounting effects which might arise from that said review. The institutions were informed that they should report this exercise to the Inspection Services by 30 September 2013.

All the institutions met the deadline set, although some of them brought forward the review, incorporating it in the interim financial information for the first half of the year. The remainder of this Box describes the process followed by the Banco de España to undertake the analysis described and the preliminary results obtained for the system as a whole.

Process followed by the Banco de España

In order to promote uniform compliance by institutions with this review of the accounting classification of refinanced and restructured transactions, as well as their coverage, the Banco de España has carried out a strict process of coordination and verification of the criteria to be applied by the institutions, which has two phases.

– The first phase of the process, which was completed on the days leading up to 30 September, consisted of discussing with the institutions the main criteria that, in the opinion of the Banco de España, should be used to identify a transaction as refinanced. In this process of interaction with the industry, the different cases contained in the banking databases have been considered, with a notable improvement in the process of coordination of the application of the criteria.

  Institutions were required to study on an individual basis their entire portfolio, so that the process of self assessment will

1 For the purposes of this box, refinancing and restructuring transactions are considered equivalent, since they both have the same origin (economic or legal reasons relating to financial difficulties) and purpose (to help borrowers pay their debt).

CLASSIFICATION OF THE PORTFOLIO OF REFINANCED AND RESTRUCTURED LOANS

€m	Starting situation	Situation following the corrections as at 30 September 2013
Standard	73,557	48,193
Sub-standard	37,218	40,888
Doubtful	71,660	92,224

SOURCE: Banco de España.

have included all kinds of transactions, irrespective of size. However, in this first phase the inspection teams of the Banco de España have been mainly focused on the correct identification of refinanced or restructured transactions that, due to their small size or characteristics, are not usually analysed individually (retail mortgage, consumer and SME portfolios).

– The second phase, currently under way, will involve finalising the reviews of the inspection teams, which will include an analysis of borrowers through specific samples and of the refinancing databases that have been requested. This will be done using a specially designed tool.

In the preparatory work for this study, the four risk indicators that are observed in refinancing and restructuring and that are considered relevant for their analysis were identified: ability to pay/recurrent income; collateralisation; payment of outstanding interest; and maturity of the refinancing. Depending on the degree of compliance with these factors, it was considered that the institutions should classify the transactions into standard, sub-standard or doubtful. The greater the compliance with the factors, the better the classification of the transaction.

Also, the "cure" criteria that sub-standard or doubtful transactions must observed to be upgraded in their classification following a refinancing or restructuring were defined. The cure criterion is related to the existence of sustained payment for 6 or 12 months, depending on the maturity of the transaction, or whether a capital reduction of at least 10% occurs.

With respect to the provision coverage of transactions, a minimum of 15% would be envisaged for sub-standard and 25% for doubtful, with the collateral taken into account to determine the provision base, provided that its value is supported by an up-to-date valuation.

Preliminary data obtained

In order to standardise and process the results obtained from the study, the institutions were requested to provide preliminary data with the impact of the review at each of them. The first provisional results were received on 15 September, relating to March 2013 data, the final data being sent on 30 September.

The preliminary information sent by the institutions and pending verification in the second phase of this work, shows that the percentage of loans that have been refinanced is particularly high in the real estate developers sector, 45% of the total loans, as against 12% for large firms, 16% for SMEs and 10% for retail mortgages.

On the preliminary data, after applying the reclassification criteria mentioned above, the amount of standard assets within the refinanced portfolio would fall from €73,557 million to €48,193 million, with doubtful rising from €71,660 million to €92,224 million. Thus, one can appreciate a sharp fall in the standard portfolio (35%), a moderate increase in the sub-standard category (10%) and a significant increase in the doubtful category (29%). Accordingly, there is a significant reclassification from the standard category to doubtful. This occurs in all segments, but it is in the real estate developers segment that the effect is most visible: standard assets fall by more than 50% in this sector, while in the rest the fall is one third.

As these figures show, institutions have reported a high degree of recognition of the deterioration of credit risk. When this report was written, on the basis of the preliminary data, which are subject to changes that might arise from the second phase of the above-mentioned revision process, additional provisioning requirements amounted to around €5 billion. In any event, the institutions' income statement will be able to withstand the provisioning requirements resulting from the exercise.

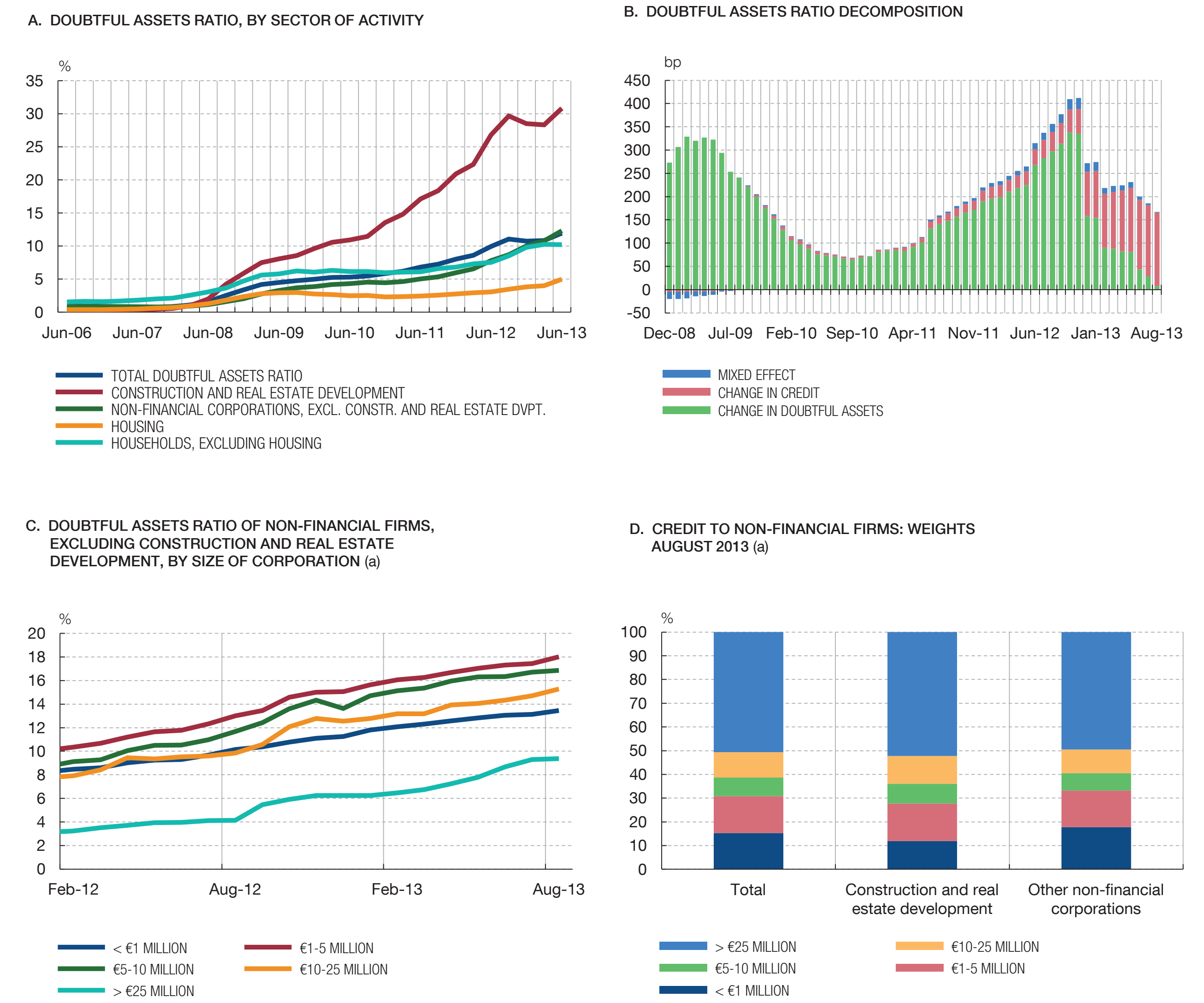
Credit dynamics as an explanatory factor of the rise in the doubtful assets ratio has gained relative importance during the last year.

A second factor which explains the upward trend of the doubtful assets ratio is the fall in credit. Thus, the doubtful assets ratio increases because doubtful assets increase (the numerator of the ratio), but also because credit decreases (the denominator of the ratio). This second explanatory factor has become more important during recent months (see Chart 2.4.B), especially for Group 1 and 2 banks, since the transfer of assets to Sareb has come on top of the credit dynamics. For the other banks, credit dynamics also explain a growing percentage of the increase in the doubtful assets ratios, but to a lesser extent. Thus, in June 2013 it explained 23.4%, compared with 15.1% a year earlier.

The doubtful assets ratio increased across the board for non-financial corporations, although it continued to be significantly higher for construction and real estate development firms

The doubtful assets ratio by sector of activity, on quarterly data, was 30.8% in June 2013 for construction and real estate development activities (see Chart 2.4.A). For the other sectors of activity, the doubtful assets ratio rose from 7.8% in June 2012 to 12.3% in June 2013 (see Chart 2.4.A). The increase in the doubtful assets ratio for non-financial firms other than construction and real estate development ones was broad-based across sectors of activity, and among groups of institutions, although its rate of increase and level

DOUBTFUL ASSETS RATIOS FOR CREDIT TO THE RESIDENT PRIVATE SECTOR CHART 2.4
Business in Spain, ID. Deposit institutions



SOURCE: Banco de España.

a Corporation size is proxied by the volume of bank debt reported to the Banco de España Central Credit Register.

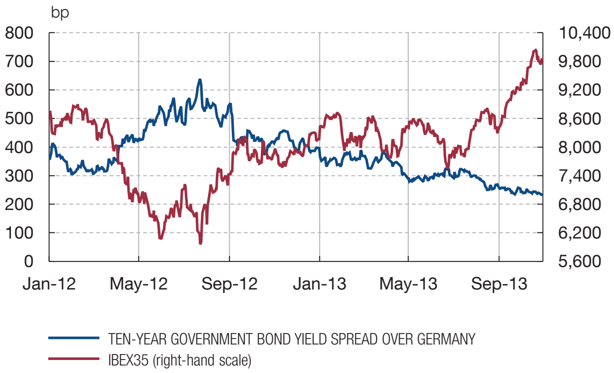
is higher for Group 1 and 2 banks (24.4% in June 2013, up 10.3 pp in the last year) than for the other institutions (10.1% in June 2013, up 3.6 pp since June 2012).

The doubtful assets ratio also increased for non-financial corporations when they are distinguished by firm size

When non-financial corporations other than construction and real estate development firms are distinguished on the basis of their size, approximated by the volume of bank debt reported to the CCR, the doubtful assets ratio shows a rising profile for the firms irrespective of their size (see Chart 2.4.C). This general rising trend in the doubtful assets ratio by size class, is compatible with differences between size classes in the level of the doubtful assets ratio. Thus, the larger firms (with more than €25 million of bank debt reported to the CCR), with a relative weight in credit of 51% (see Chart 2.4.D), recorded the lowest doubtful assets ratio (8.7% in June 2013). For the other non-financial corporations, excluding construction and real estate development ones, the doubtful assets ratios are relatively similar by size class, ranging from 13% to 17.3%. Firms with a volume of bank debt reported to the CCR of up to €5 million, whose relative weight in credit is 31%, have a doubtful assets ratio of 15.2%.

FINANCIAL AND RISK INDICATORS (a) CHART 2.5

A. IBEX35 AND RISK PREMIUM



B. SYSTEMIC RISK INDICATOR (SRI) (b)

SOURCES: Datastream, ECB and Banco de España.

a Latest data: 30 October 2013.
b For a detailed explanation of this indicator, see Box 1.1 from FSR May 2013.

The doubtful assets ratio of individuals increased, and both the increment in the ratio and its level were higher in credit for purposes other than house purchase

The doubtful assets ratio of individuals reached 5.8% in June 2013, compared with 3.8% a year earlier. Both the level of the ratio and its rate of increase were lower in credit for house purchase (5% in June 2013, 1.9 pp more than a year earlier) than in credit for purposes other than house purchase (10.2% in June 2013, 2.7 pp more than a year earlier; see Chart 2.4.A). The lower level of doubtful assets in credit for house purchase than in that for other purposes is also observed in the various groups of banks. Thus for Group 1 and 2 banks the doubtful assets ratio of credit for house purchase was 6.7% in June 2013, against 17.2% in the case of credit for purposes other than house purchase. For other banks, the doubtful assets ratios of these segments were, respectively, 4.4% and 8.4%.

In short, the doubtful assets ratio of the resident private sector in business in Spain increased in the first half of 2013, this increase being fairly widespread across groups of banks and economic sectors. The rise in the doubtful assets ratio, however, is increasingly explained by the downward momentum of credit, the denominator of the ratio, and this effect will foreseeably continue in the coming months. Also, there will be isolated increases in the doubtful assets ratio as a result of the revision of refinanced loans which the Banco de España requested banks to carry out (see Box 2.1). In any event, regardless of any isolated effects such as that mentioned above, if the macroeconomic recovery does not become firmer, an additional increase in bank doubtful assets is very likely.

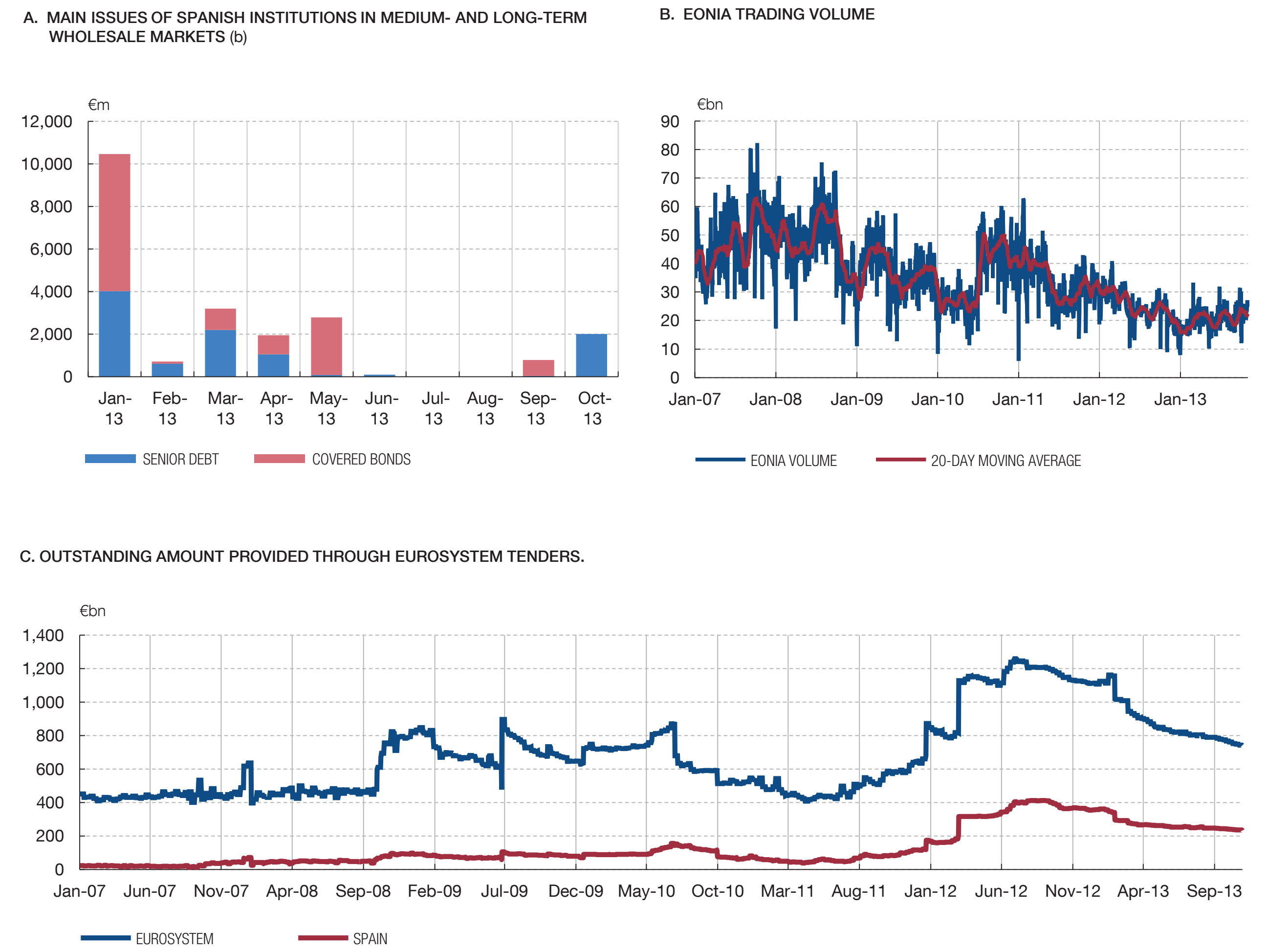
In June 2013 foreclosed assets (those whose ownership passes to banks as a result of legal debt enforcement proceedings or as a result of standard debt-settlement procedures between the debtor and the bank) decreased by 14.4% year-on-year, compared with growth of 28.7% a year earlier. However, this decrease was concentrated particularly in Group 1 and 2 banks (–71.2%), while the other banks as a whole posted a positive rate of change (20.7%), although the rate was lower than in June 2012 (28.8%).

2.1.3 Funding of the banking sector

In recent months funding conditions on wholesale financial markets have improved…

In the last few months the Spanish stock market has improved, as reflected by the gains posted by the Ibex 35, while the spread of the 10-year Spanish government bond over the German benchmark has been falling gradually from its high in mid-2012 (see Chart 2.5.A). This improvement in funding conditions on the wholesale financial markets is also perceptible in the lower credit risk premia of securities issued by resident financial and non-financial firms.

WHOLESALE FUNDING (a) CHART 2.6



SOURCES: Bloomberg, Dealogic and Banco de España.

a Latest data: 30 October 2013.
b Senior debt and covered bond issues are included. Retained issues are not included.

… in line with a notable decrease in the systemic risk indicators for Spain

These developments in the **financial markets** are reflected in the progressive reduction of the level of systemic risk in Spain, measured through the SRI[6] (see Chart 2.5.B). Despite isolated increases, the trend in the past year is downward and has taken the level of systemic risk to low levels near to those recorded in the period before the crisis. This decrease is reflected in all the markets whose information is condensed in the SRI (the securities, money, bank funding and government debt markets), where the levels of tension have dropped significantly since September 2012. In the last few weeks the narrowing of the spread between Spanish and German 10-year bonds has helped to keep reducing the level of systemic risk. Broadly, the decrease in the volatility of the aforementioned markets, along with the increase in confidence and the resulting improvement in market sentiment, explain the drop in the level of systemic risk in Spain over the past year.

The extent of Spanish banks' recourse to the wholesale debt markets has varied both...

Against this background, some Spanish banks have issued debt on the wholesale markets in 2013. These issues were most notable at the beginning of the year, when securities were being placed not only by the larger banks with an international presence, but also by others

6 This indicator developed by the Banco de España is explained in Box 1.1 of the May 2013 Financial Stability Report. It is intended to reflect the situation of systemic risk in Spain and changes therein.

...across banks and during the year

of smaller relative size and with operations more focussed on Spain (see Chart 2.6.A). Then the activity of Spanish banks in the wholesale markets relaxed and held at more moderate levels. It came to a halt in the summer months and subsequently resumed with some additional issues being launched. In any event, the pace of debt issuance on wholesale markets by banks depends not only on financial market conditions, but also on each bank's strategic objectives and their achievement during the year. In this respect, a strategic objective of many Spanish banks is to reduce their dependence on wholesale funds in their funding mix by raising the relative weight of retail deposits against a background of falls in lending. These factors and the still relatively high cost of wholesale issues (largely a result of financial market fragmentation) explain much of the decrease in issuance since the beginning of the year despite the improved financial market conditions.

Since the beginning of 2013 interbank market trading has shown a certain increase, albeit moderate and discontinuous

The euro area money markets have continued to be characterised by weak activity. Thus, since the last FSR the volume of interbank market activity has not changed significantly, holding at levels below those of previous years. This trend is reflected in the EONIA trading volumes, which in 2012 continued their downward path to stand at a low at the end of that year (see Chart 2.6.B). However, since the beginning of 2013 there has been a certain, albeit moderate and discontinuous, increase in trading. For its part, the Spanish interbank market has performed similarly to the EONIA.

Spanish banks significantly reduced their gross recourse to the Eurosystem in the past year

In view of this lack of interbank market activity and the unlimited provision of liquidity by the Eurosystem, European credit institutions continued to resort extensively to Eurosystem funds. That said, 2013 saw a continuation of the downtrend in their recourse to these funds which began in summer 2012, when the ECB Governing Council announced its intention to intervene under certain conditions in the secondary markets for euro area sovereign debt. Thereafter, the ability of some European banks to raise funds on the primary markets improved considerably, allowing them to lower their purchases in new tenders and to begin repaying early a portion of the funds received in the two 3-year tenders allotted in late 2011 and early 2012. The outstanding balance of the ECB tenders (Chart 2.6.C) for the total Eurosystem and for banks resident in Spain shows how, from the end of September 2012 to the end of September 2013, banks resident in Spain reduced their gross recourse to the Eurosystem by €142 billion (–37%), while the outstanding balance in the total Eurosystem decreased by €409 billion (–35%).

Consequently, the share of loans to Spanish banks in the total Eurosystem decreased in this period. The weight of the outstanding balance of tender allotments to Spanish-resident banks with respect to the total provided by the Eurosystem was 31% in September 2013, compared with an average of 33% a year earlier.

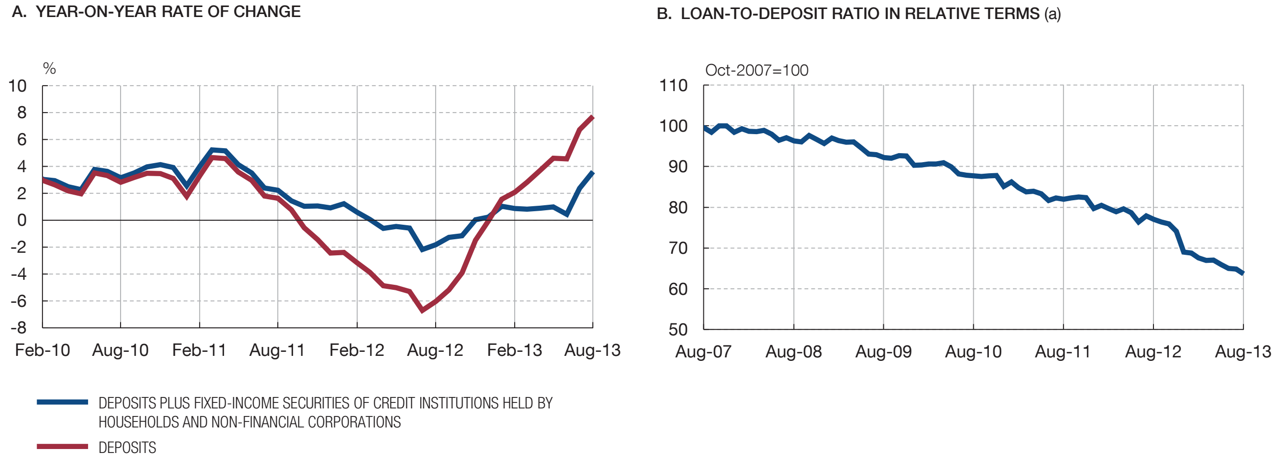
The year-on-year growth rates of deposits from households and non-financial corporations continue to rise…

The relative improvement in the funding conditions faced by Spanish banks is reflected in the behaviour of deposits from households and non-financial corporations. The most recent data available, relating to August 2013, show a year-on-year change of 7.7% (see Chart 2.7.A), in the same line as the positive year-on-year rates of change recorded since the beginning of 2013, after the negative trend last year manifested by year-on-year falls in deposits from households and non-financial corporations of around 6% at mid-2012.

The retail funding raised by banks includes not only deposits from households and non-financial corporations, but also other fixed-income instruments, such as promissory notes, which can act as substitutes of the former from the standpoint of households and firms, but do not alter the basis of retail funding for banks. This type of fixed-income securities attracted greater commercial interest in relation to deposits as a result of the 2011 changes

DEPOSITS FROM HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS, ID

CHART 2.7



SOURCE: Banco de España.

a Loans to households and non-financial firms net of provisions. Deposits from households and non-financial firms plus fixed-income securities of credit institutions held by households and non-financial firms.

in the contributions to the Deposit Guarantee Fund based on the risks assumed (fixed-income securities are not subject to such contributions). This interest has gradually faded owing to further changes in deposit-related contributions to the Deposit Guarantee Fund in August 2012.

…a trend which persists when the analysis also includes the fixed-income securities issued by banks which are held by households and non-financial corporations

In any event, analysis of the total of deposits and fixed-income securities which are issued by banks and held by households and non-financial corporations shows that the retail funds raised by banks fell in 2012 (–2% year-on-year), but that the fall was much smaller than the aforementioned –6% decrease in deposits. The aforementioned recovery in deposits in the year to date is also apparent when these are analysed on an overall basis with securities. Thus positive year-on-year rates of change have been recorded in 2013 and the latest figure available, that for August 2013, was a rate of 3.6%.

The behaviour of loans and deposits explains the progressive narrowing of the retail funding gap of the Spanish banking sector

This recent behaviour of deposits, along with the progressive deleveraging of the banking sector, is producing a progressive narrowing of the retail funding gap, i.e. the difference between loans and retail deposits (see Chart 2.7.B). The asset transfer to Sareb in December 2012 and in February 2013 by the Group 1 and 2 banks, respectively, is apparent in the greater intensity of deleveraging in those months, although it does not alter the observed general trend of progressive reduction in the retail funding gap.

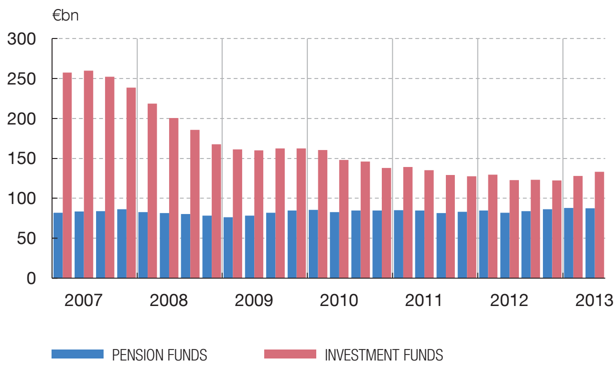
Investment funds, amidst a certain improvement in the financial markets, have recorded positive net subscriptions since the start of 2013

Throughout 2013 the net assets of investment funds reversed the downward trend which has charactised their behaviour since the outset of the crisis, whereas the net assets of pension funds maintained their trend of relative stability (see Chart 2.8.A). The net assets of investment funds increased by more than €5 billion in each of the first two quarters of 2013 (see Chart 2.8.A). This increase was explained by both the positive yields (except in June) and the higher net subscriptions, particularly the latter, whose contribution to the change in net assets of the funds was positive in all months of 2013, breaking the trend of negative net subscriptions initiated in March 2011 (see Chart 2.8.B). Net subscriptions increased in 2013 in all types of funds (money market, bond, equity and international), showing steady growth except in equity funds, whose behaviour was more unsteady during the year. The reason for this trend may be the relative improvement in the financial

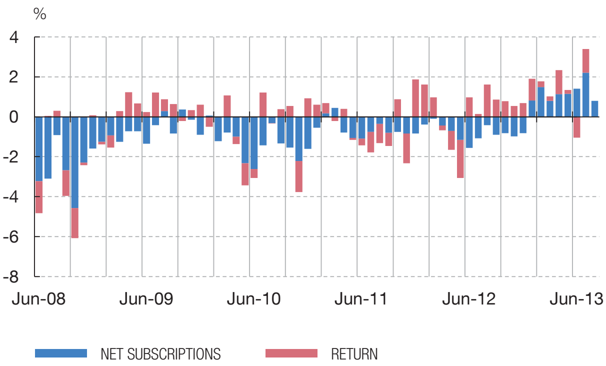
INVESTMENT AND PENSION FUNDS

CHART 2.8

A. ASSETS OF INVESTMENT FUNDS AND PENSION FUNDS



B. CONTRIBUTION TO CHANGE IN NET ASSET VALUE OF RETURNS AND OF NET SUBSCRIPTIONS



SOURCE: INVERCO.

markets in 2013, prompted to some extent by the downtrend in bank deposit interest rates. In any event, the substitution effects between investment funds and bank deposits are relatively limited, taking into account that the cumulative net subscriptions to date amount to 1.3% of the volume of deposits and fixed-income securities of credit institutions held by households and non-financial corporations, and that these products have different risk characteristics.

2.2 Profitability

The Spanish banking sector recorded a profit in June 2013 following the sizeable loss of 2012

Deposit-taking institutions recorded consolidated income attributable to the controlling entity of €8,246 million between January and June 2013 (see Table 2.2), which contrasts with the negative income of somewhat more than €3 billion in the same period of the previous year. The positive income posted in June 2013 by banks as a whole signified a return on assets (ROA) of 0.45%, against –0.17% in the previous year. The return on equity (ROE) was 7.8% in June 2013, contrasting with the –3% observed in June 2012.

A portion of the income of total deposit-taking institutions to June 2013 was obtained by the Group 1 and 2 banks (see Chart 2.9.A), which recorded very high losses in 2012, in which year the financial system incurred a loss of around €43 billion, largely due to the provisions which had to be set aside in that period.

A large part of the improvement in the income statement is explained by the lower provisions than in 2012 as a result of Royal Decree-Laws 2/2012 and 18/2012

In this respect, some of the improvement in the results of deposit-taking insitutions as a whole and of those belonging to Groups 1 and 2 was due to the lower provisions recorded this year compared with the previous year, when banks had to meet the additional requirements imposed by Royal Decree Laws 2/2012 and 18/2012 passed in the first half of 2012, requiring an extraordinary effort from them. These lower provisioning needs offset the downward pressure on business margins, particularly the net interest margin, in a setting of low interest rates, weaker lending activity and rising doubtful assets, which do not earn interest.

Net interest income fell in June 2013, in year-on-year terms …

Net interest income declined by 10.8% year-on-year[7] between January and June 2013, with falls in both financial revenues (12.9%) and financial costs (15.4%). In terms of average total assets, net interest income fell from 1.86% in June 2012 to 1.7% in June 2013.

7 In 2012 various integration processes were carried out between institutions, so that the perimeter changed between 2012 and 2013. This affects the comparability of these years, and in particular tends to reduce the rates of change of the various income statement items, albeit not very significantly, so that the growth of net interest income would have been slightly greater had this effect not occurred.

CONSOLIDATED INCOME STATEMENT
Deposit institutions. January-June 2013

TABLE 2.2

	Jun-13		Jun-12	Jun-13
	€m	% Change Jun-13/Jun-12	% ATA	% ATA
Financial revenue	61,268	-12.9	3.74	3.35
Financial costs	30,131	-15.4	1.89	1.65
Net interest income	31,137	-10.8	1.86	1.70
Return from capital instruments	639	-43.8	0.06	0.03
Share of profit or loss of entities accounted for using the equity method	2,920	98.9	0.08	0.16
Net commissions	11,600	-3.1	0.64	0.64
Gains and losses on financial assets and liabilities	9,145	104.3	0.24	0.50
Other operating income	-1,481	—	-0.08	-0.08
Gross income	53,961	3.4	2.78	2.95
Operating expenses	26,026	4.1	1.33	1.42
Net operating income	27,935	2.7	1.45	1.53
Asset impairment losses (specific and general provisions)	16,930	-41.9	1.55	0.93
Provisioning expense (net)	2,413	-16.6	0.15	0.13
Operating profit	8,592	—	-0.26	0.47
Asset impairment losses (assets other than loans and credits)	2,163	-50.2	0.23	0.12
Income from disposals (net)	4,612	240.1	0.07	0.25
Profit before tax	11,040	—	-0.42	0.60
Net income	9,429	—	-0.25	0.52
MEMORANDUM ITEM				
Income attributable to the controlling entity	8,246	—	-0.17	0.45

SOURCE: Banco de España.

… as a consequence of the lower level of activity and, especially, of the evolution of average lending and borrowing rates

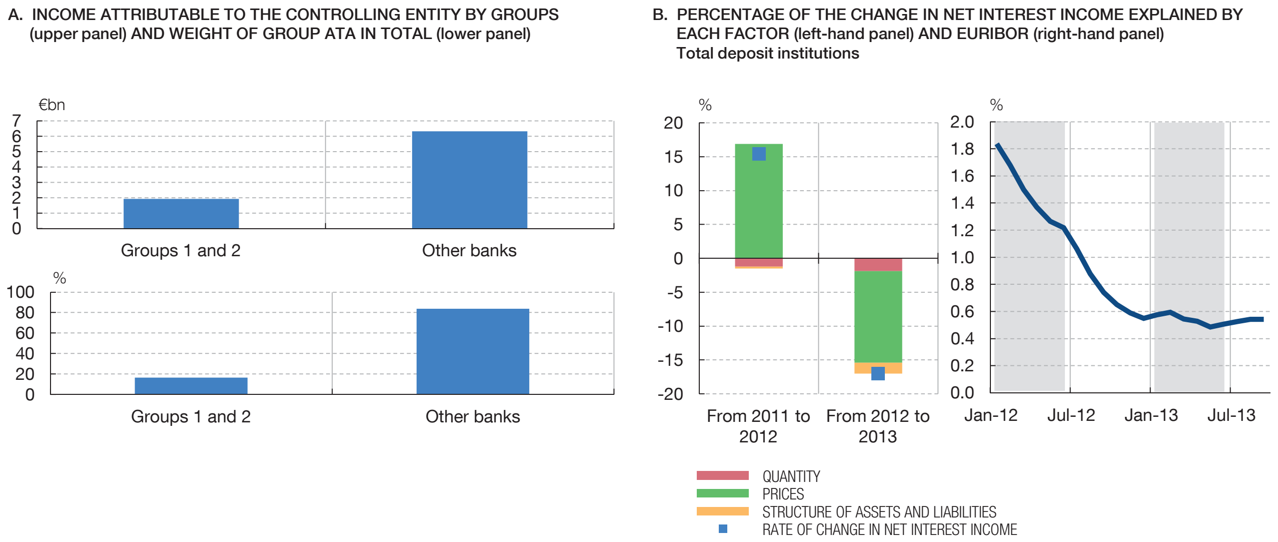
This decline in net interest income was seen both in business in Spain and in business abroad, although it was more pronounced in the former. On individual financial statement data, there was a significant fall, of 17% in June 2013 in relation to the same period a year earlier. This decline in net interest income is partly explained by the reduction in activity, against a background of falling credit, but is mostly attributable to the negative evolution of average lending rates and average borrowing costs (price effect; see Chart 2.9.B). The notable reduction in interest rates, and in particular in Euribor, between the first half of 2012 (1.48% on average) and the first half of 2013 (0.54% on average), translated into a decline in the return on assets (downward repricing of the portfolio), which was greater than the reduction observed in the average cost of borrowing, partly due to a lower remuneration of deposits, leading to a decline in the spread between these two periods. The above-mentioned reduction in net interest income was observed for Group 1 and 2 banks and for other banks alike.

Fees and commissions, in particular those most closely linked to banking activity, have fallen…

Net fees and commissions fell by 3.1% in June 2013 year-on-year, although in terms of ATA the change was not significant. Within fees and commissions, those associated with the selling of financial products grew most, while the largest year-on-year falls were recorded by those others linked to credit and debit card services and to securities services. The decline in net fees and commissions was much more notable at institutions belonging to Groups 1 and 2 (–11.9% year-on-year, as against a fall of 2.1% at other deposit institutions), which is probably related to the lower activity of these institutions in the context of their restructuring plans.

PROFIT AND NET INTEREST INCOME

CHART 2.9



SOURCE: Banco de España.

… while gains and losses on financial assets and liabilities rose significantly, although they were boosted by one-off operations

Gains and losses on financial assets and liabilities increased between June 2012 and June 2013 very notably, to reach €9,145 million. The improved performance of gains and losses on financial assets and liabilities is observed both in the case of Group 1 and 2 banks and in that of other banks. However, the increase in the gains and losses on financial assets and liabilities was significantly greater for the Group 1 and 2 banks (an increase of 335% in the reference period), which is explained by the existence of a non-recurring gain arising from hybrid instrument management exercises.

Operating expenses grew by 4.1% year-on-year in June 2013. There was a significant difference in the behaviour of the growth of operating expenses between Group 1 and 2 banks (fall of 13.2% in June 2013 year-on-year) and other banks (increase in operating expenses of 6.3%). The increase in operating expenses for institutions not belonging to Groups 1 and 2 is explained by staff compensation expenses incurred in the first half by certain institutions conducting workforce restructuring processes.

Institutions continue to reduce offices and staff, as part of the process of restructuring their operating costs

Spanish institutions are continuing to reduce their staff and offices, in an attempt to reduce their operating costs. From the highs reached in June 2008, Group 1 and 2 banks have reduced the number of their employees by some 30%, which is similar to the percentage reduction in the number of offices. This means that office numbers now stand at their late 1990s levels, while employees are at the level existing in around 2000. In addition, from now until 2017, according to the restructuring plans associated with the recapitalisation of these institutions, there will be reductions of around 50% from the highs reached in June 2008 (see Chart 2.10.A and B). For other institutions, there were also significant falls in the number of offices and employees between June 2008 and June 2013 (see Chart 2.10.A and B).

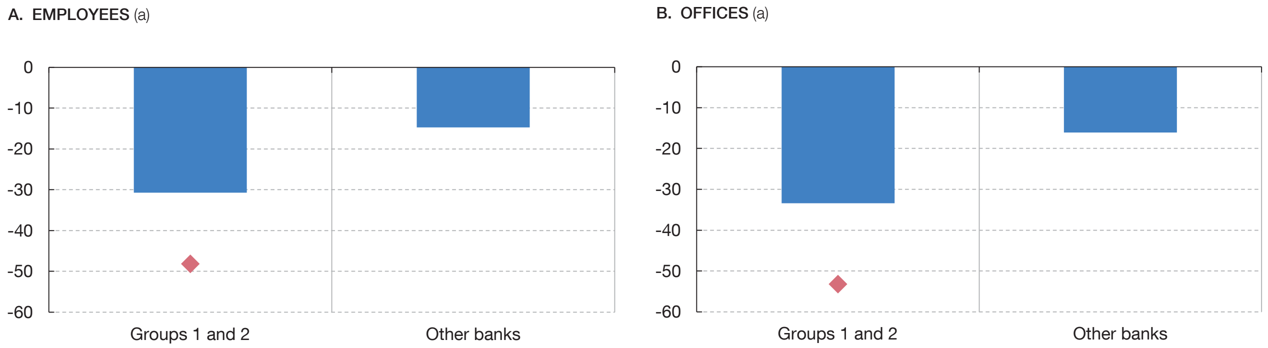
Asset impairment losses declined significantly last year, as in 2012 they were boosted by RDLs 2/2012 and 18/2012

Asset impairment losses, which show specific and general provisions, fell very significantly last year (–41.9% in June 2013). In terms of ATA, the reduction was similar, from 1.55% of ATA in June 2012 to 0.93% a year later. Although most provisions made by institutions in 2012 as a consequence of RDLs 2/2012 and 18/2012 were concentrated in the latter part of the year, many institutions, to a greater or lesser degree, made some of the provisions in the first half of the year. Thus, although doubtful assets, in an economic context like the

NUMBER OF EMPLOYEES AND OFFICES. BUSINESS IN SPAIN

CHART 2.10

Percentage change in June 2013 relative to the maximum (June 2008). Deposit institutions, ID

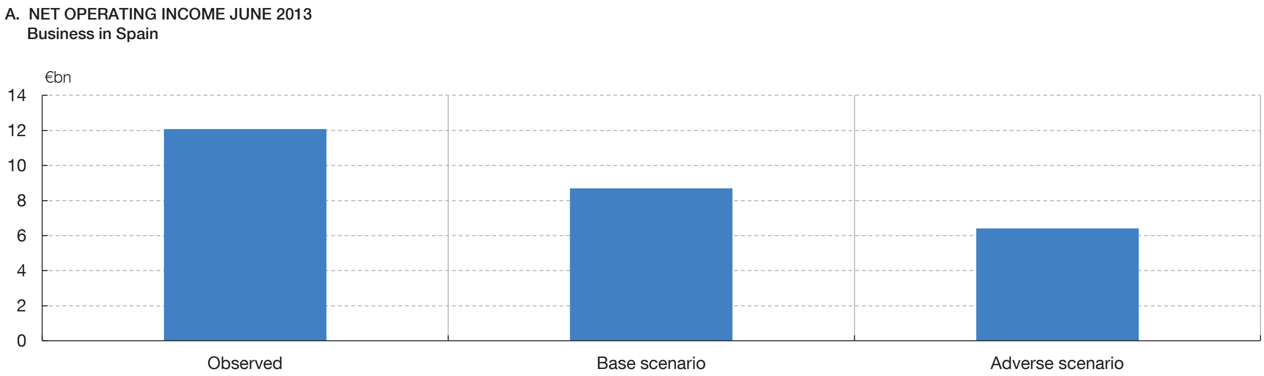


SOURCE: Banco de España.

a The point represents the projection of the change in the number of employees/offices in 2017 relative to the maximum reached by each variable, given the restructuring plans approved by the European Commission for Groups 1 and 2.

BANKING SYSTEM PROFITABILITY

CHART 2.11



SOURCE: Banco de España.

a To make the comparison homogeneous with the observed results in June, annual estimates by the external consultant are divided by two.

present one, continued to increase, the provisions to be made, in comparison with those recorded in 2012, fell significantly, from more than 100% of net operating income in June and December 2012 to 61% in June 2013.

Impairment losses on other assets, largely relating to foreclosed assets, behaved similarly, for the same reasons, with a sharp fall in relation to June 2012 (–50.2%) and a significant fall as a proportion of ATA (0.23% in June 2012 as against 0.12% a year later). Also, the percentage by which they reduce net operating income fell, from 16% in June 2012 and 35% in December 2012, to 8% in June 2013.

In short, the consolidated earnings of Spanish institutions have moved from heavy losses in 2012 to positive levels in the first half of 2013. This is basically a consequence of the lower provisioning required, following the extraordinary efforts made last year as a result of the adjustments to the valuation of assets relating to property development. Margins are under pressure from the lower volumes of activity, the high level of non-productive assets and the net flow of doubtful assets, against a background of low interest rates, which restrict income from financial activity. The leeway available to institutions to face the challenges deriving from the current macroeconomic context is limited, which should lead them to persevere in their policy of containing operating costs and efficiency gains. In any event, it should be noted that in the current year to date, the net operating income generated by Spanish institutions in their business in Spain is greater than that considered by the external consultancy in the stress test last year, both under the adverse and the baseline scenarios (see Chart 2.11).

2.3 Solvency

The solvency ratio increased for deposit institutions, due to the recapitalisation of the Group 1 and 2 banks and the improvement recorded by other banks over the past year

The solvency ratio of deposit institutions reached 12% in June 2013, an increase of 59 bp from June 2012 (see Chart 2.12). This increase shows the effect of the recapitalisations carried out last year, since not all the Group 1 and 2 banks had been recapitalised by mid-2012. When these institutions excluded, the level of the ratio remains at 12.4% in both years. The tier 1 ratio for all institutions stood at 10.8%, up 1.1 pp from a year earlier. This ratio also increased in the case of institutions other than those in Groups 1 and 2, from 10.6% in June 2012 to 11% in June 2013. Law 9/2012, implemented by CBE 7/2012, provides that credit institutions must have core capital of at least 9%, in accordance with recommendation 2011/1 of the European Banking Authority. Under this Law, institutions must comply with these new requirements from 1 January 2013. In June 2013, the core capital ratio according to Law 9/2012 stood at 10.5%.

The proportion of higher quality capital is increasing

Total own funds fell by 8.5% from June 2012 owing to the sharp reduction in tier 2 capital (34.5%) and the fall of 3.1% in tier 1 capital. This behaviour shows the change in profile that is occurring in the composition of own funds, given that higher quality capital is displacing other capital, as can be seen in the fact that its relative weight in the total has risen from 72% in June 2008 to 94% in mid-2013 (see Chart 2.13.B).

Within tier 1, capital continued to grow strongly (31.2% in June 2013), although it has slowed slightly (5.4 pp) since 2012. Its buoyancy was more than offset by the negative behaviour of reserves, the decline in which quickened to a fall of 21.8%, and by the fall in preference shares (see Chart 2.13.C).

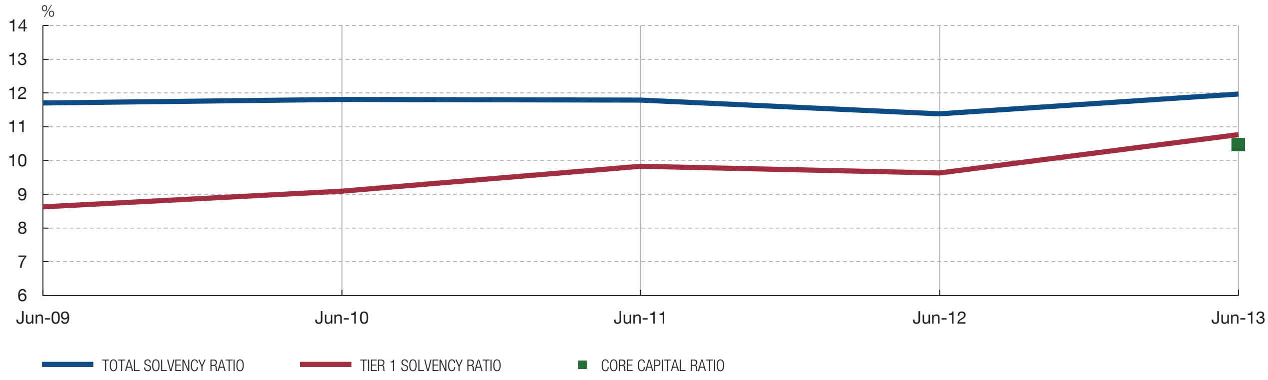
The above-mentioned decline in tier 2 capital occurred through the reduction in subordinated financing, which decreased in June 2012 at a rate of 43.2% relative to the same period a year earlier (see Chart 2.13.D).

Total requirements decreased in keeping with the decline in credit

The fall in total requirements quickened after they decreased by 13% driven by requirements for credit risk which dropped at a rate of 14.7% (9 pp higher than the decline in June 2012) as a result of the ongoing reduction of credit (see Chart 2.13.A).

SOLVENCY
Deposit institutions

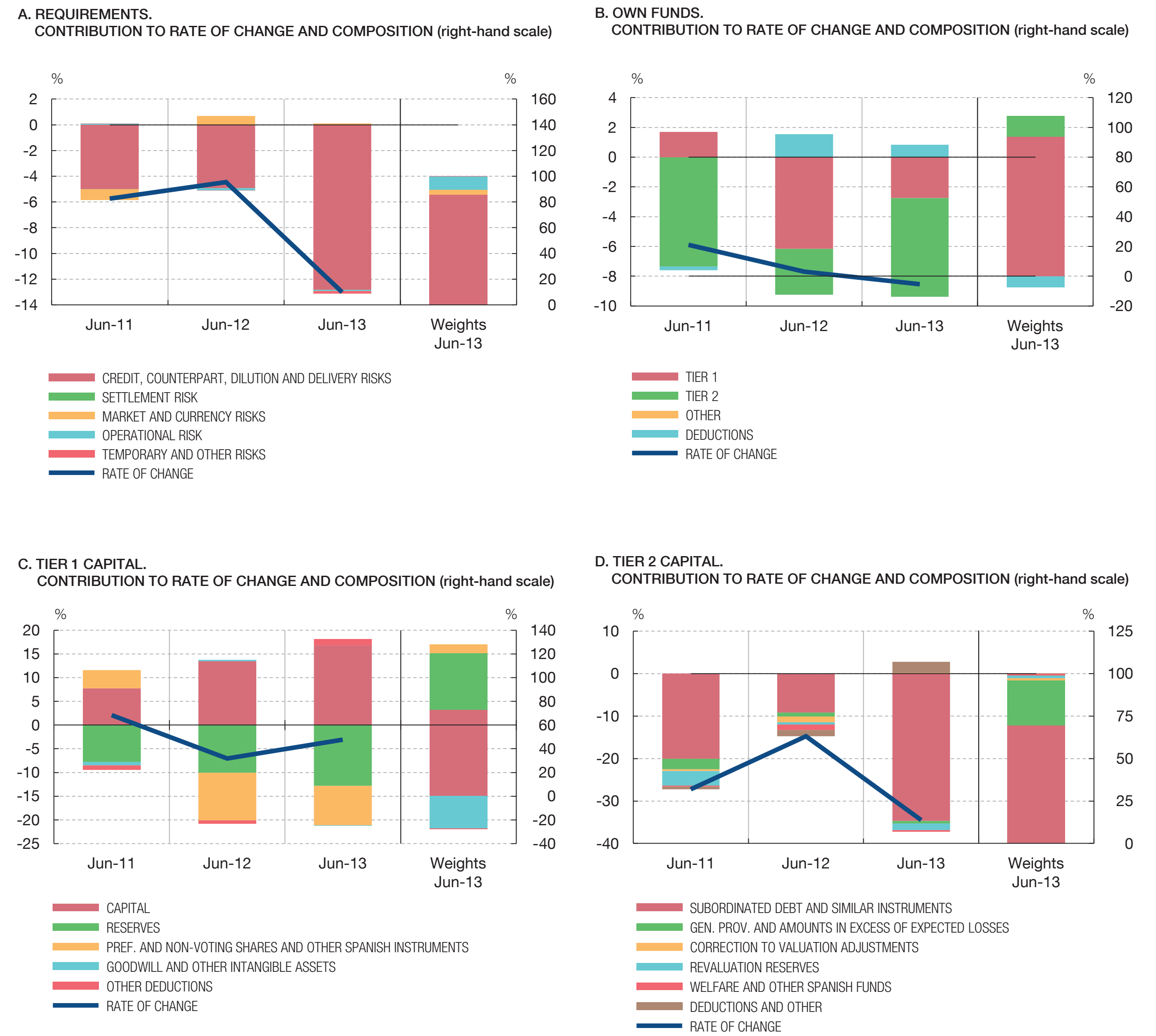
CHART 2.12



SOURCE: Banco de España.

CAPITAL REQUIREMENTS AND OWN FUNDS
Deposit institutions excluding Group 1 and 2 institutions

CHART 2.13



SOURCE: Banco de España.

As indicated above, the tier 1 ratio also improved for Group 1 and 2 banks. These banks combine an increase in capital, as a result of recapitalisation, with lower credit risk requirements.

Market perception of Spanish banks, judging by their price to book value, has improved during the year

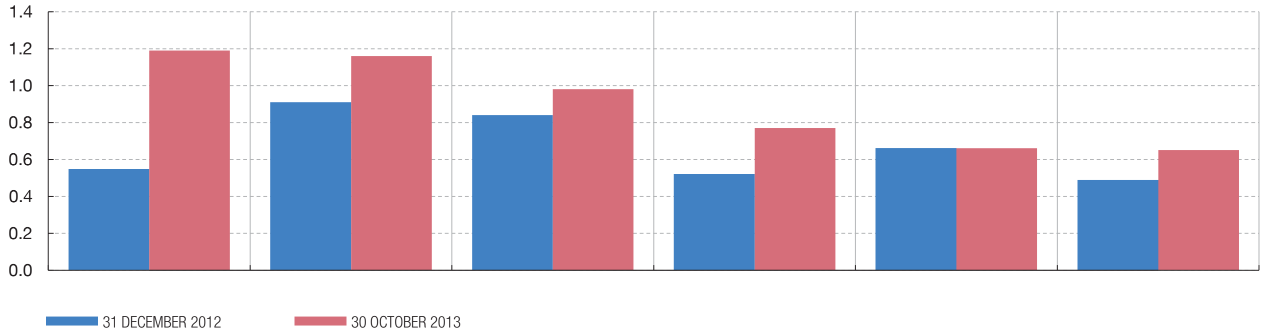
Market perception of the situation of Spanish banks, in light of the substantial increase in their stock market prices, has improved. As a result of these developments the market's assessment of these banks on the basis of their price to book value has improved, reflecting less mistrust of Spanish banks' balance sheets following the restructuring process and the stress tests performed last year in Spain (see Chart 2.14.A). A comparison of the main listed Spanish banks and the main European ones on the basis of price to book value shows that Spanish banks are in a medium-high position in relation to their peers (see Chart 2.14.B).

In any event, despite the improvement of Spanish banks' solvency ratios and the market's perception of their price to book value, in a setting in which, notwithstanding the signs of recovery, uncertainties remain about the economy in Spain and in the euro area, the Banco

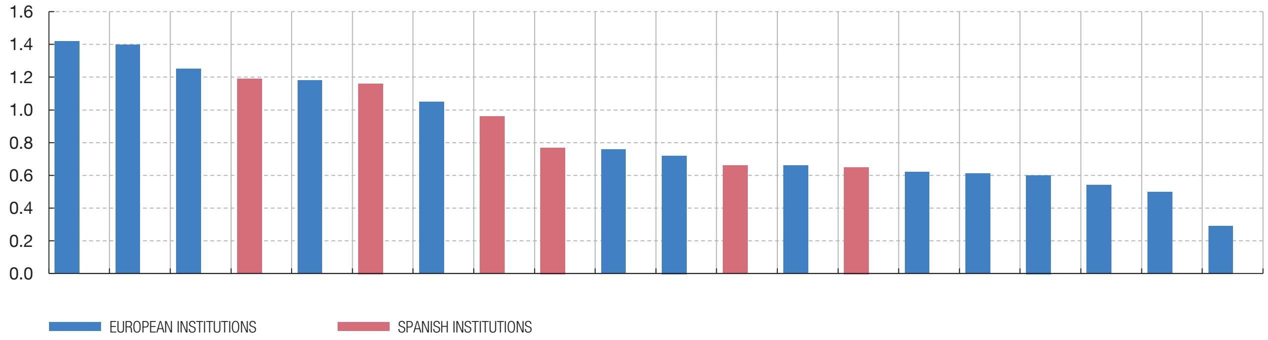
MARKET INFORMATION
Price-to-book value

CHART 2.14

A. PRICE-TO-BOOK VALUE. SPANISH GROUP 0 QUOTED INSTITUTIONS (a)



B. PRICE-TO-BOOK VALUE. LARGEST EUROPEAN INSTITUTIONS (b)



SOURCE: Datastream.

a Each pair of bars represents an institution.
b Each bar represents an institution. Latest data: 30 October 2013.

de España published a recommendation in June 2013 that dividend distribution policies should be guided by caution and ensuring that there is an adequate level of capital at all times. Thus, during 2013, it was recommended, taking into consideration the specific features of each institution, that cash dividends should not exceed 25% of attributable consolidated profit. Similarly, each institution should consider that payments in the form of shares, insofar as they are a recurring practice, must be commensurate with the growth of shares outstanding and with the earnings performance. This measure comes on top of the supervisory measures adopted in accordance with the MoU signed by the Spanish and European authorities which, together with the institutions' own actions, currently ensure that there are appropriate solvency levels based on the risks assumed.

Delegations from the European Commission, the ECB and the IMF carried out the fourth review of the financial sector assistance programme for the Spanish banking sector between 16 and 27 September. These organisations have published[8] the preliminary findings of their review which underlines that the reform programme of Spain's financial sector remains on track[9]. They also mention, in order to enhance proactive monitoring of

8 Joint press release of the European Commission and the ECB: http://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/InformacionInteres/ReestructuracionSectorFinanciero/Arc/Fic/presbce2013_128e.pdf
IMF press release: http://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/InformacionInteres/ReestructuracionSectorFinanciero/Arc/Fic/fmi300913en.pdf

9 Section 4.3 analyses this matter in more detail.

the financial sector, the work by the Banco de España on a tool to develop forward-looking scenario exercises on Spanish banks on a regular basis. Accordingly, Chapter 3 of this report presents the initial results of the methodology developed by the Banco de España to undertake forward-looking analyses to evaluate the solvency of Spanish banks in various macroeconomic scenarios.

3 DEVELOPMENT OF A TOOL TO REGULARLY CONDUCT FORWARD-LOOKING ANALYSES OF SPANISH BANKS. METHODOLOGY AND INITIAL AGGREGATE RESULTS

3.1 Objectives

The last FSR indicated (in Box 2.3) that the Banco de España would include “prospective” or forward-looking analyses as part of the tool kit available to the supervisor to assess each bank and, were it necessary, to be able to take measures to correct their solvency situation. The Banco de España has thus adopted best international (US and UK) practices in the area, incorporating forward-looking analyses to its range of supervisory tools. The present chapter presents the work conducted since then by the Banco de España to equip itself with a tool (known as the FLESB — the Forward-Looking Exercise on Spanish Banks) that enables the solvency of Spanish banks in the face of different macroeconomic scenarios to be evaluated. It should be noted that this is not a forecast of the future solvency of institutions, but rather a sensitivity analysis in respect of a pre-determined set of shocks.

This tool will be subject to continuous improvement over time, both in the initial data it requires and in the calculation methods it uses. It is thereby sought to incorporate the best international practices in this area, in which connection assessment and advice has been sought from independent experts with long-dated experience in the field.

What is presented in this FSR is, therefore, the first step of this evolutionary process, including the results obtained for the system as a whole. From a methodological perspective, the objective initially pursued has been to develop a framework enabling a sensitivity analysis to be conducted using the supervisor’s own models (a top-down approach), and therefore without the need to draw on each bank’s own models. Nevetherless, this framework is enriched with numerous granular elements (a bottom-up approach) at the level of individual loans, including their guarantees. These bottom-up elements stem from the information that banks gather, prepare and process in their lending and guarantee-management activities, and from the forward-looking information they prepare on the different components of their income statements.

The above-mentioned methodological developments have benefited substantially from interaction with the external consultant that carried out the bottom-up stress tests last year as part of the MoU between the Spanish and European authorities. This has allowed the tool’s application, scope and calibration to be improved. It will also provide for further improvements in the immediate future, particularly in methodological aspects and giving greater depth to elements already considered in the bottom-up approach.

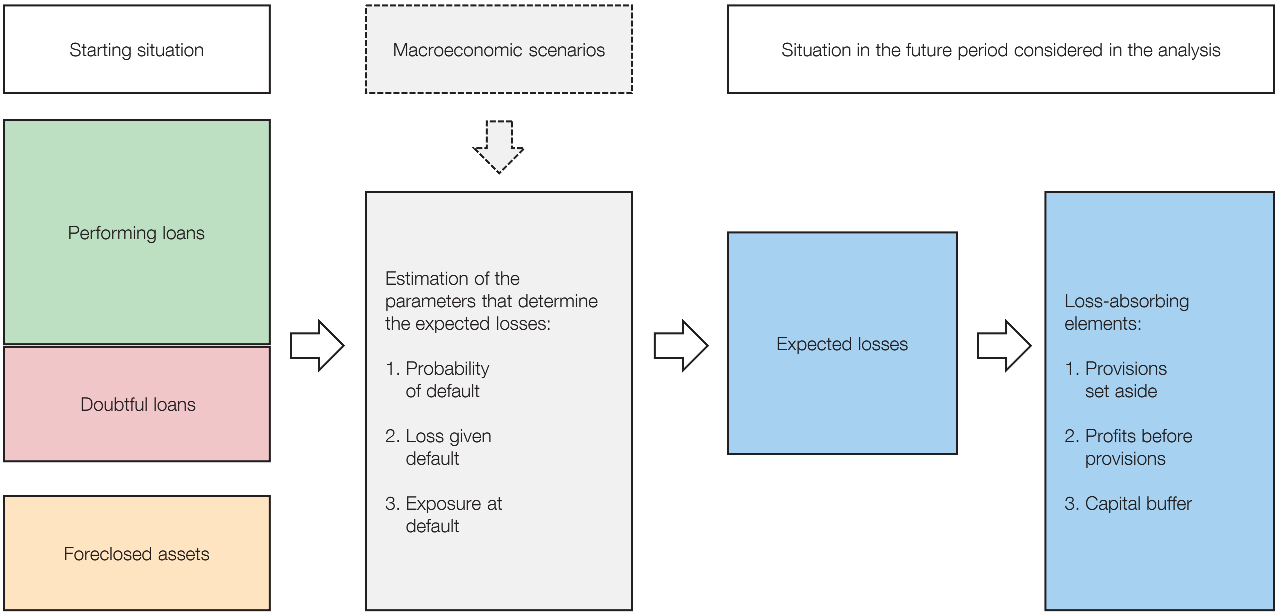
The rest of this chapter broadly describes the approach followed, detailing thereafter the most significant features of the methodology employed in the development of each of the parts making up the FLESB. It concludes with the results obtained for the system as a whole.

3.2 General framework

As stated, the aim of the FLESB is to evaluate the solvency of banks in the face of different scenarios over a specific time horizon. Hence, given macroeconomic scenarios that must be demanding but plausible, the tool calculates the expected losses over the related period of time, and compares these losses with the elements banks have at hand to withstand such losses. As Chart 3.1 shows, projecting expected losses requires that three basic parameters be calculated: probabilities of default, losses in the event of default and exposure in the event of default. The elements at hand at banks to withstand expected losses will be provisions previously set aside, the profits before provisions that are estimated for the horizon of the analysis and the capital buffer available.

GENERAL FRAMEWORK FOR OPERATION OF THE FLESB

CHART 3.1



SOURCE: Banco de España.

The macroeconomic scenarios used in an exercise such as that pursued with the FLESB (see the section on results for an analysis of the specific scenarios used) must be demanding, but plausible, since otherwise they would give rise to results that are difficult to interpret and, above all, to translate, if necessary, into supervisory actions. A baseline scenario is used which, subject to the uncertainty macroeconomic forecasting entails in general, is the best estimate of future macroeconomic developments. That is to say, it is the scenario that is most likely to occur. In addition to the baseline scenario, several alternative scenarios with a differing degree of severity are considered which, in any event, must conform to a minimum level of occurrence, in an attempt to measure the sensitivity of banks' position to unfavourable, but plausible, changes in the economic environment. These alternative scenarios are generated in connection with the medium-term macroeconomic forecasting models regularly used by the Banco de España, by imposing adverse exogenous shocks on the baseline scenario.

3.3 Data needed for the analysis

Any tool for conducting forward-looking analyses with a high bottom-up component requires databases with a high level of granularity. The Banco de España has databases that offer a high degree of detail at the level of loans and borrowers, with information too on the collateral available. These are listed below:

— Central Credit Register (CCR). The Banco de España receives monthly information on loans granted by each of the banks operating in Spain to their customers, grouped by specific characteristics, if the financing extended to such customers exceeds the minimum threshold of €6,000. The CCR information allows the banking book to be segmented into performing and doubtful loans, and also provides information about other relevant characteristics for analysing the risk associated with each lending operation with the same characteristics (maturity, collateral, sector of activity, province, etc.). The CCR information is used to estimate several of the parameters needed in the calculation of expected losses, such as probabilities of default, cure rates and the credit conversion factors.

— Loans inventory. In addition, through the on-site inspections of institutions, highly detailed loan-by-loan information is available as is that on the collateral (if any) associated with the operation. Concerning collateral, the appraised value and the date of the latest appraisal are available, as is information on its geographical location. The loan-by-loan information here makes up the banks' lending portfolio in its entirety. This level of detail is also available for foreclosed assets. The loans inventory, and the details provided on collateral, comprise the underlying information for the calculation of the collateral values and that of the foreclosed assets.

These granular databases provide for detailed information on more than 30 million loans with their respective collateral, and some 3.5 million credit facilities.

— Credit Risk Distribution (DRC, by its Spanish abbreviation) table. What are involved here are supervisory reports made available to each institution in which the lending portfolio is detailed with a specific segmentation by purpose of the operations, and which allow the accounting information prepared by institutions to be reconciled with the details of the loans in the aforementioned loans inventory. This information is used as an anchor point and a means of reconciliation of the different databases used.

— Institutions' projections of their income statements. The projections made by institutions of their income statements over the time horizon of the exercise are also available. This information is used, after conducting a plausibility analysis, as detailed below, to project profits before provisions.

— Other information. Other information that institutions send periodically to the Banco de España as a result of their regulatory obligations or of supervisory requirements is also used. This includes, inter alia, information on balance sheets, income statements, the regulatory capital ratio and own funds requirements.

3.4 Constituent elements of the expected losses projection

The expected loss over the analysis period is the result of expected losses for performing loans, for loans classified as doubtful initially and that arising from foreclosures. For the portfolio of performing loans, the parameters for calculating the expected loss are the probability of default, the loss in the event of default and exposure in the event of default. For doubtful loans (given that they are already in a situation of default, i.e. their probability of default is 1), losses given default and the exposure must be calculated. Finally, the expected loss for foreclosed assets will depend on the projection of their value at the time of sale. Detailed below is the methodology applied for the calculation of each of the parameters needed to calculate the expected loss.

3.4.1 Probabilities of default

The probabilities of default are estimated using the loan-by-loan information from the CCR. The loan-by-loan data are aggregated by credit segment in accordance with those included in the DRC statements which, as stated above, are the supervisory templates used as the starting point for obtaining the initial exposure in each portfolio and also for grounding and appropriately reconciling the different databases used. The six credit segments considered are: real estate developers, construction, corporates, SMEs, retail mortgage lending and consumer credit. This segment-based aggregation is done for each bank and over the period from 2000 to date in order to construct a panel with which to estimate a probability of default model based on macroeconomic variables for each lending portfolio segment. Modelling probabilities of default with macroeconomic variables enables the former to be linked to the macroeconomic scenarios used in the exercise.

Once the probabilities of default have been modelled, and thereby linked to the scenario, three adjustments are applied to them.

— The probabilities of default are anchored to the detailed information on credit portfolios in the Credit Risk Distribution table. As a result, consistency is ensured between databases by classifying information on credit sub-portfolios, since the information available in the CCR is segmented by economic activity codes (NACE codes), and what is taken directly from the institutions' loan portfolio is segmented in accordance with the purpose of the loan.

— In calculating the probability of default, the relative size of the default is taken into consideration. In this regard, potential biases in estimated probabilities of default are thus avoided when the degree of heterogeneity of the size of loans in a portfolio is high.

— The probabilities of default are adjusted to incorporate the detailed refinancing analysis conducted by the Banco de España over the course of 2013 (see Box 2.1). The amount of loans recently reclassified from performing or sub-standard to doubtful are taken into consideration to adjust the starting point of the probabilities of default upwards

3.4.2 LOSS IN THE EVENT OF DEFAULT

Loss in the event of default is broken down into two factors. Once a loan becomes doubtful, it will be necessary to evaluate what possibility there is of it being cured, i.e. that it may be recovered and return to a situation of normality (first factor). If the loan has become doubtful and is not cured, the effective associated loss (second factor) will have to be calculated, taking into account the value of the collateral, if any.

Cures

When a loan defaults, it is possible with the passage of time that the borrower may find sufficient funds to repay the debt and, therefore, the default "is cured". The information available in the CCR enables cure curves to be calculated, distinguishing between the six credit segments considered. That is to say, it is estimated, for each segment on the basis of the CCR loan-by-loan information, what percentage of the doubtful asset will be recovered on average, once a certain time in doubtful status has elapsed. In calculating cures, a distinction has been made between those loans that have been less time in a situation of default and those others that have had this status for longer. This is because, conceivably, the longer a loan has a default status, the more difficult it will be for it to return to normal.

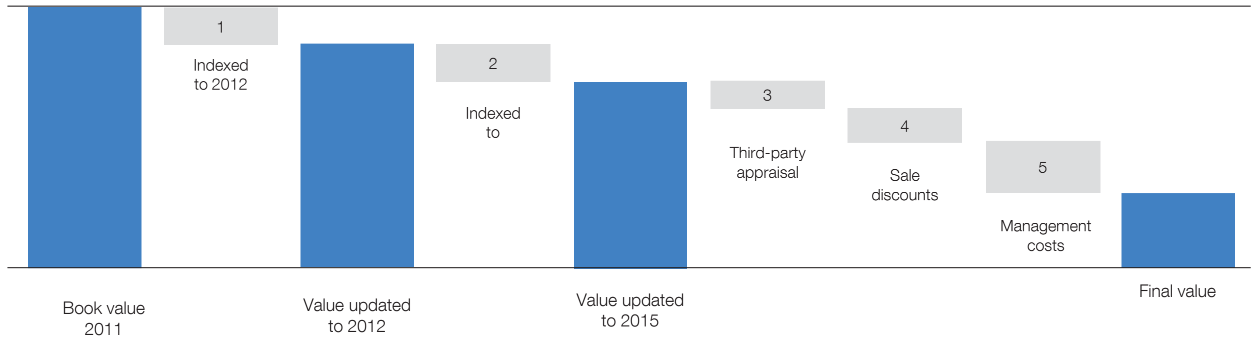
The calculation of the cure curves based on the CCR is not free from difficulty, as the loans that have been cured are not specifically identified. The difficulty arises because, when a loan is removed from the doubtful category, it is not possible to identify accurately the underlying reason. To resolve this, it has been opted with the current roll-out of the FLESB to take the more conservative option, based on the expert criterion of the consultant who has offered advice on the development of the FLESB.

Valuation of collateral

For operations that default and that do not cure, the associated losses must be calculated. Thus, operations which do not cure finally turn into a loss if there is no collateral posted,

COLLATERAL VALUATION ADJUSTMENT TO CALCULATE LOSS GIVEN DEFAULT

CHART 3.2



SOURCE: Banco de España.

or else the value of the collateral has to be calculated to obtain the residual value that the unpaid loan can yield once the attendant guarantee has been liquidated.

As the FLESB currently stands, the granular information available to the Banco de España and that obtained from the external consultant in the stress tests conducted last year has been intensively used. As earlier discussed, this information consists of the geographical location of the collateral, the type of asset, the appraised value at the latest available date and specific elements that reduce the value of the collateral owing to the potential existence of biases in appraisals, upkeep and management costs of such collateral, and the discounts institutions apply when selling such collateral (steps 3, 4 and 5 in Chart 3.2). Prices that are as granular as possible (by province, type of collateral, etc.) have been used to update the value of the collateral at the time it is used as a starting point of the forward-looking exercise, as has an own model to project the prices of such collateral over the time horizon in which the exercise is conducted (steps 1 and 2 in Chart 3.2). As a result, the final value of the collateral is obtained which, once deducted from the unpaid exposure, provides the final value of the loss in the original loan operation.

Given the granularity of the information available in 2011 and 2012 (the latter being the starting point of the exercise), it has been necessary to proportionately adjust the amounts so that there should be no discrepancies and to adjust the initial population characteristics to the level of the arrival point, as well as considering the transfer of assets from the Group 1 and 2 institutions to Sareb.

3.4.3 Exposure in the event of default

The CCR contains information on credit facilities, the amount drawn down at each point in time, the amount available and the date on which a company defaults. Accordingly, it is possible to calculate the drawn down credit conversion factor for each operation or, expressed otherwise, the additional amount of credit a company has by using its credit facility precisely at the moment prior to default. The conversion factors are calculated by credit segment and measure the increase in credit drawn down as a proportion of the amount available in the final period before default. If this is calculated operation by operation and aggregated by segment, implicit regard is had to differences in conversion factors that may arise as a result of the different collateral provided under each credit facility.

3.4.4 Foreclosed assets

The foregoing treatment applied for the calculation of the value of collateral is very similar to that applied to the calculation of expected losses on foreclosed assets (see Chart 3.2). In this case, in addition to taking into account the transfers to Sareb, stratified sampling has been used to move from highly granular asset-by-asset information, as at end-2011, to more aggregated information in the case of 2012, the rest of the adjustments being very similar to those seen for collateral.

3.5 Absorption of losses

As a result of the interaction between the highly granular databases of loans, collateral, credit lines and foreclosed assets, the models estimated and the various scenarios used, it is possible to obtain estimations of expected losses by portfolio, by bank and under various macroeconomic scenarios. These expected losses are compared with the resources available at each bank for absorbing them.

3.5.1 Provisions

The first element available for absorbing expected losses are the loan-loss provisions existing at the starting date of the exercise. In this case, all the existing provisions for business in Spain are calculated because it is deemed that they could all be used in the hypothetical case that expected losses materialised. Only existing provisions in Spain are used, excluding those from abroad, because the target of this forward-looking exercise is the loan portfolios of the resident private sector in Spain. Expected losses in the first year are compared with the volume of provisions. If they are lower, the surplus provisions are used in the following year to absorb the losses of the second year, and so on.

3.5.2 Profits before provisions

If at any time the provisions are insufficient for absorbing expected losses, the amount not covered is charged to profits. Consequently, once the provisions have been exhausted, it is possible to use profits (before provisions) to absorb the remaining expected losses. This requires estimating profits before provisions for the time horizon considered and for each scenario.

In order to project profits before provisions, as they currently stand, the FLESB has adopted an all-encompassing approach.

— An econometric model of different factors determining the various items in the income statement was developed, linking these items to the usual macroeconomic variables. The level of detail is significant, with ROA, the cost of liabilities, the volume of interest-earning assets and interest-bearing liabilities, fees (broken down by type), gains or losses on financial transactions and operating expenses having being modelled separately. This model provides for an aggregate numerical reference, linked to each macroeconomic scenario, which enables the greater or lesser plausibility of the complementary expert approach developed to be assessed.

— An expert approach has been developed, based on the forward-looking information on each institution's balance sheet and income statement, to which access is had as a result of the banking supervision function. The information thus obtained is filtered and in some cases institutions' over-optimistic estimations are adjusted both in terms of prices and volumes. The consistency of the information with the aggregate macroeconomic scenario is also checked. Similarly, the impact of the expected losses is incorporated by suspending the accrual of interest in proportion to these losses. The exercise involving the expert estimation of profits before provisions is complemented by adjusting the other items to the information available to the supervision teams, which filter the institutions' plans, and to other judgments which are taken into account in the scenario. For institutions with business abroad an estimation of their net profit, with a 30% haircut, is used, in line with the common practice in this type of exercises performed recently in Spain.

Once profits before provisions adjusted for outliers and in line with the baseline scenario and the above-mentioned aggregate quantitative forecast are obtained, the results under scenarios which are further removed from the baseline scenario are obtained, incorporating the effect of higher expected losses in net interest income and more stringent assumptions in the evolution of the other captions, using the supervisor's expert opinion and econometric estimations as a point of reference.

3.5.3 Final impact on capital

Once the provisions and profits available to the institutions have been used, the remainder of the expected losses impacts capital directly, reducing it by that amount . The net amount of capital is compared with risk-weighted assets to determine the solvency ratio. Risk-weighted assets show changes in assets according to the scenario.

The comparison of this ratio at the end of the analysis period with the capital threshold established determines the institution's relative solvency position in the various scenarios envisaged. The supervisor will use this information in conjunction with other data to enrich the dialogue process with the institution about its current and future capital levels in relation to its risk level.

3.6 Approach of the exercise

As explained throughout this chapter, the FLESB has been conceived as a tool necessarily subject to development and continuous refinements. As it currently stands, it has been deemed of use for evaluating the solvency position of the Spanish banking sector as part of a forward-looking exercise that considers different macroeconomic scenarios.

The aim is to perform a forward-looking exercise which, taking December 2012 as a starting point, spans a three-year period from 2013 to 2015.

The exercise targets the resident private sector's credit portfolio in respect of business in Spain, along with foreclosed assets. The institutions' credit portfolio has been divided into six segments (real estate developers, construction, corporates, SMEs, retail mortgage lending and consumer loans), which have been modelled taking into account the characteristics proper to the loans and collateral comprising them.

It has been borne in mind that in December 2012 and in February 2013 the Group 1 and 2 institutions, respectively, transferred assets to Sareb, with these assets and the provisions set aside for them therefore being excluded from the scope of the analysis.

The set of institutions considered are those which were already included in the exercise conducted last year by the external consultant as part of the implementation of the MoU, i.e. Santander, BBVA, La Caixa, Kutxabank, Sabadell, Bankinter, Unicaja, BMN, Liberbank, Popular, NCG, CX, BFA-Bankia, Ibercaja-Caja3, and CEISS.

The benchmark capital ratio for this exercise is Common Equity Tier 1 (CET1), as defined in the CRR/CRD IV, the regulations that transpose Basel III into the EU regulatory framework. In accordance with these regulations, both the calculation of CET1 and the application of specific deductions and filters needed for its calculation will be progressive during its phase-in from 2014 to 2017. The rules envisage a minimum regulatory capital (in terms of

1 If any institution has an asset protection scheme which guarantees coverage of a portion of the losses by an external third party, this will have been taken into account in the final calculation of the expected loss absorption capacity.

CET1) of 4% in 2014, which would be increased to 4.5% from 2015. For the purposes of this forward-looking exercise, the timetable set by the regulations for the definition of the CET1 ratio that will be in force at each point in time[2] has been considered.

3.7 Macroeconomic scenarios used in the exercise

In performing this exercise, two alternative and less probable scenarios, characterised by a more unfavourable performance of the main macro-magnitudes, have been considered along with a baseline macroeconomic scenario. To design these scenarios a macroeconometric model was used in which a set of technical assumptions was introduced regarding the path of the main exogenous variables, such as interest rates and the growth of world markets, up to end-2015.

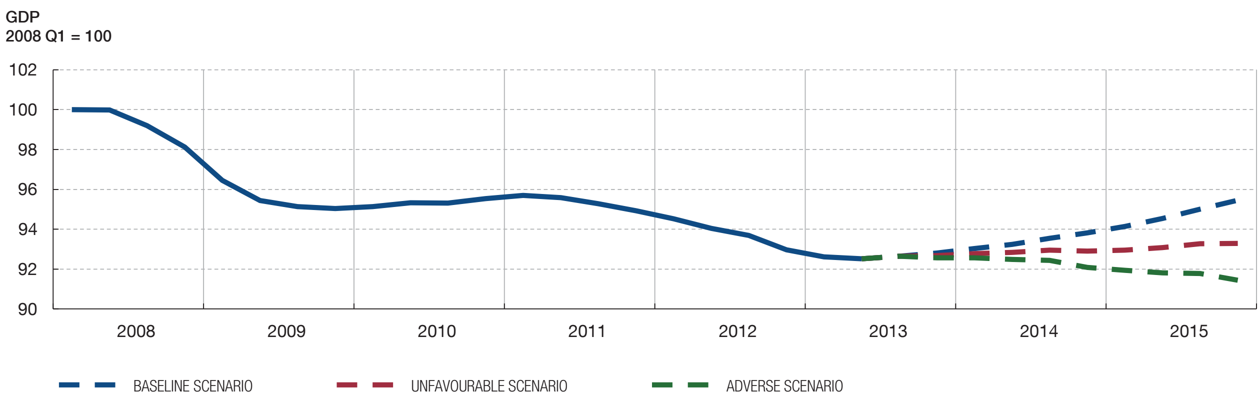
In the baseline scenario, the economy experiences a modest recovery, which progressively gains momentum as private domestic demand increasingly accompanies exports as the driver of activity. In this scenario, the Spanish economy would leave behind the second recession it has undergone since the start of the crisis, although the level of GDP at the end of the exercise's horizon would still be noticeably lower than the cyclical peak attained in 2008 Q1 (see Chart 3.3). What is involved, therefore, is a scenario of gradual growth, in which the process of correction and adjustment of the imbalances built up in the Spanish economy continues.

In the first alternative scenario, known as the unfavourable scenario, the Spanish economy would scarcely grow in the period considered (see Chart 3.3), meaning that cumulative output growth from 2013 to 2015 would be 1.7 pp lower than in the baseline scenario. This gap between cumulative GDP growth in the two scenarios matches that implicit in the forecasts of the IMF's October 2013 World Economic Outlook, forecasts which, among those recently formulated by national and international agencies, are those that project a more adverse baseline scenario. In the construction of this scenario, consideration is given to a hypothetical worsening of financial conditions, a slowdown in Spanish export markets and a fall-off in the level of domestic private spending. In combination, these factors would give rise to a virtual flattening of GDP, with a more negative performance by the main variables of interest, such as unemployment and house prices, compared with the baseline scenario.

2 Given that the exercise begins in 2013, it has been assumed, for the sake of consistency with the definition of the capital ratio, that the definition established in CRR/CRD IV for 2014 would have to be met as at that date.

PATH OF GDP UNDER DIFFERENT SCENARIOS

CHART 3.3



SOURCES: INE and Banco de España.

Finally, the second alternative macroeconomic scenario, known as the adverse scenario, would entail a fresh dip in the Spanish economy (see Chart 3.3). This scenario, which is assigned a very low probability of occurrence, would be the outcome of a combination of adverse shocks qualitatively similar to those of the foregoing unfavourable scenario, but on a more acute scale. Specifically, the gap between GDP growth in the baseline scenario and in this more pessimistic scenario would almost be double the cumulative relative loss in the unfavourable scenario, climbing to 3.2 pp, with a likewise more adverse impact on the other macro-financial variables.

3.8 Results of the exercise

The results of the exercise show that the expected losses generated in the credit portfolio, and in the foreclosed assets portfolio, grow as the scenario worsens. That is to say, as the macroeconomic scenario moves away from the baseline scenario and pivots towards an adverse scenario whose likelihood of occurrence is low, the resulting expected losses naturally increase.

Thus, in the baseline scenario, the expected losses in the credit portfolio resulting from the exercise for the 2013-2015 period account for 7.6% of total credit. This percentage of expected loss would be 8.8% in the unfavourable scenario and would rise to 9.7% in the adverse scenario. If the expected losses associated with foreclosures are added, the percentages of total expected losses (losses on the credit portfolio plus those of the foreclosures over credit exposures plus foreclosures) increase in each of the scenarios. Thus, in the baseline scenario, the percentage of total expected loss would be 10.1%, standing at 11.3% for the unfavourable scenario and at 12.1% for the adverse scenario. The increase in the expected loss in the unfavourable scenario with respect to the baseline scenario is 12%, whereas this increase in the expected loss is 20.4% between the baseline and the adverse scenarios.

The resources available to withstand these expected losses, that grow in terms of the degree of severity of the scenario, follow the opposite path, i.e. they fall from the baseline scenario to the adverse scenario, but moderately so. On one hand, the volume of provisions the institutions have is constant in the three scenarios, as this is the amount that is already set aside on balance sheets at the start of the exercise. This amount accounts for 8.8% of the total exposure analysed. In relation to the overall expected loss in each scenario, the total provisions already set aside would account for 87.3% of total expected losses in the baseline scenario, 78% in the unfavourable scenario and 72.5% in the adverse scenario.

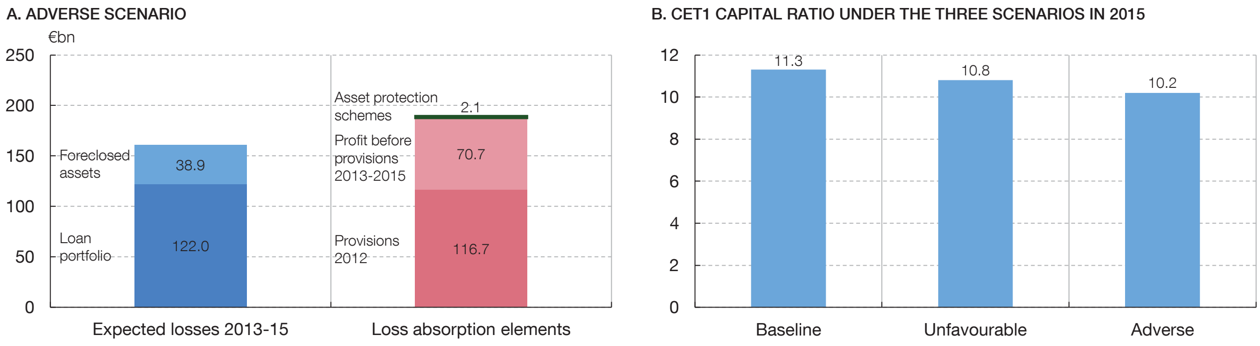
On the other hand, the resources available from the use of asset protection schemes[3] increase as losses do (i.e. there are more resources available from APSs in the adverse scenario than in the baseline one), but their relative increase and their total amount are of little significance for the institutions analysed as a whole. Hence, in the baseline scenario, the APSs available account for 1% of expected losses, for 1.2% in the unfavourable scenario and rise to 1.3% in the adverse scenario.

Finally, institutions' pre-provisioning profit-generating capacity diminishes as the scenario becomes more severe, essentially as a reflection of the greater reduction in activity and as a result of more defaults arising in the adverse scenario, which entails the interruption of the accrual of interest for a higher volume of assets. A further factor is the conservative

3 Asset protection schemes (APSs) are resources available for absorbing expected losses for those institutions that have such schemes. They have been taken into account in each specific case, and always according to the concession and approval conditions under which these APSs were agreed.

AGGREGATE RESULTS OF THE FORWARD-LOOKING ANALYSIS EXERCISE ON THE SENSITIVITY OF SPANISH BANKS' SOLVENCY TO DIFFERENT MACROECONOMIC SCENARIOS

CHART 3.4



SOURCE: Banco de España.

assumptions made in respect of the generation of income on financial transactions, which is considered to be zero in 2014 and 2015 under the adverse scenario, with only that recorded in the first half of the year being admitted in 2013. The pre-provisioning profit-generating capacity of institutions as a whole analysed in the baseline scenario would cover 58.2% of the expected losses generated in that scenario. As stated, the reduction in profits and, more importantly, the increase in total expected losses in the different scenarios explains the gradual reduction in this percentage of coverage. Thus, in the unfavourable scenario, the coverage of total expected losses with profits before provisions would be 50.1%, while in the adverse scenario it would be 43.9%.

Accordingly, the results of the exercise for the set of 15 institutions analysed show a fairly comfortable solvency position at the aggregate level in 2015. Chart 3.4.A shows that, in the worst scenario, loss-absorption capacity exceeds expected losses by €28.6 billion. The CET1 capital ratio in 2015 for the institutions considered as a whole would be 11.3% in the baseline scenario, 10.8% in the unfavourable scenario and 10.2% in the adverse scenario (see Chart 3.4 B).

The methodology used (despite using quite granular information at the level of each institution) does not allow the prospective solvency position of each bank to be estimated precisely. However, the analysis shows that all the institutions would easily satisfy the minimum levels of regulatory capital, even in the adverse scenario.

This chapter is dedicated to two issues that have differing degrees of repercussions, and on differing scales, for credit institutions. The first part reports on the main areas of progress in the creation of the Single Supervisory Mechanism (SSM), a basic pillar for achieving a Banking Union in Europe. More from a regulatory than from a structural standpoint, several developments relating to consolidation accounting regulations are analysed. The aim here is to contribute to preventing controlled financial structures from being left outside the scope of consolidation, further providing for reporting improvements that enable an assessment to be made of the risks to which non-consolidated financial structures are exposed. Finally, the chapter reports on the monitoring of the financial assistance programme for Spanish banks.

4.1 Developments concerning the Single Supervisory Mechanism (SSM)

In June 2012, the EU Heads of State and Government decided to promote the creation of a single banking supervisor…

As indicated in the last FSR, in June 2012 the Heads of State and Government of the European Union (EU) decided to create a single banking supervisor, with the aim of improving the quality of supervision in the euro area, promoting market integration and breaking the vicious link between confidence in banks and doubts over the sustainability of public debt. Underpinning the creation of a single banking supervisor was the special legislative procedure included in Article 127.6 of the Treaty on the Functioning of the European Union, which provides for the ECB to be vested with prudential supervisory powers over credit and other financial institutions, with the exception of insurance companies.

… and in December the draft regulation on the Single Supervisory Mechanism was approved ,…

On 12 December 2012, the Council of the European Union approved the Commission's draft regulation on the SSM, which is defined as a European supervisory system comprising the ECB and the competent national authorities (CNAs) of the euro area countries and of those other Member States that wish to join.

… with swift progress being made during 2013.

During 2013 swift progress has been made in defining and preparing the SSM. On 22 May 2013, the European Parliament (EP) expressed its support of the proposal, pending a final agreement on the attendant transparency and accountability arrangements. This inter-institutional agreement was reached on 12 September by the ECB and the EP, and, hereunder, the EP will have extensive access to supervisory information, including: knowledge of the contents of the Supervisory Board's meetings; approval of the designation of its chair and vice-chair, and the power to propose their dismissal; the power to initiate inquiries into supervisory errors; and the right to make written enquiries to the supervisor and to receive a prompt reply.

On 15 October the EU Council adopted the draft regulation. Consequently, in conformity with its provisions, the ECB shall effectively assume the supervisory powers granted to it under the regulation twelve months after its entry into force, provided that progress in the practical implementation of the regulation should allow it.

The three pillars of the Banking Union will be strengthened by the new capital requirements framework established under EU Regulation 2013/575 and Directive 2013/36/EU

The SSM is one of the three essential elements of the Banking Union, which also includes the establishment of a single resolution mechanism and a common deposit guarantee system. These three institutional pillars will further be strengthened by the implementation from January 2014 of the new capital requirements framework laid down by EU Regulation 2013/575 and by Directive 2013/36/EU, and by the bolstering of the European Banking Authority (EBA), whose powers will be enhanced, inter alia, to perform stress tests and request information of EU credit institutions.

The design of the second pillar of the Banking Union was launched on 10 July 2013, with the presentation by the European Commission of a proposal for a single resolution mechanism. This is currently being analysed in parallel by the working groups of the Council and the EP. They intend to set out their respective positions in October and initiate forthwith the pertinent "trilogies" phase, so as to conclude the legislative process as soon as possible, ideally in the first quarter of 2014.

Joint supervision teams will be set up for supervised institutions…

With regard to the SSM, following the mapping of the euro area countries' credit institutions, it is estimated that somewhat more than 130 institutions, representing approximately 85% of the area's banking assets, will be considered significant[1] and, therefore, will be directly supervised by the SSM. In this connection, joint supervision teams (JSTs) will be formed, including experts from the ECB and from the CNAs. The joint supervision teams will be led by an ECB coordinator and each team will be responsible for the daily supervision of a significant banking group. The remaining institutions not deemed to be significant will continue to be supervised by the national authorities, although their supervisory decisions must conform to the rules, guidelines or instructions of the ECB, which may assume direct supervision of an institution if it considers this necessary.

… while it will be sought to clearly segregate the ECB's supervisory and monetary policy functions

The draft regulation seeks to establish a clear segregation between the ECB's supervisory and monetary policy functions, with the aim of maintaining the ECB's monetary policy independence. To this end, the above-mentioned Supervisory Board (on which both national supervisors and the ECB will be represented) will be created, assisted by a Steering Committee which will carry out preparatory tasks. In addition the draft regulation contains provisions, including most notably those relating to the segregation of staff from the two functions; the setting up of a mediation panel to settle discrepancies between the ECB's Supervisory Board and its Governing Council; and financing supervision through charges.

The CNAs will continue to play an important role

The CNAs will continue to play an important role, especially during the initial stages of the new supervisory regime. As expressly acknowledged in the recitals of the draft regulation, "national supervisors have long-established expertise in the supervision of credit institutions within their territory and their economic, organisational and cultural specificities". With regard to institutions considered significant, the CNAs shall:

- Assist the ECB in the preparation and application of supervisory decisions.
- Formulate draft decisions on specific matters (e.g. on the granting or revoking of authorisations or the taking of significant stakes).
- Assist the ECB in the ongoing assessment of the position of credit institutions and in on-site verifications.
- Provide whatsoever information the ECB should require in the performance of its functions.

Preparatory work has been carried out in recent months

The preparatory work for the SSM has focused in recent months on:

- Mapping credit institutions in the euro area to determine the supervisory regime that will be applicable to them on the basis of the foregoing indications.

1 For the criteria governing whether an institution is considered significant, see the May 2013 Financial Stability Report, pp. 51 and 52.

— Writing the draft framework regulation on the organisation of its supervisory functions which the ECB, in consultation with the competent national authorities, and on the basis of a proposal by the Supervisory Board, should adopt in keeping with the proposed regulation for the SSM. This framework regulation shall also specify ECB/CNA forms of collaboration.

— The supervision manual for the main euro area credit institutions, which includes the methodology needed for the preparation of their risk profiles [namely the risk assessment system (RAS)]; the methodology for evaluating capital adequacy and liquidity; specific provisions relating to supervisory processes; and on-site inspection procedures.

— Laying down an outline for the regular sending of banks' confidential returns to the SSM, which encompasses the drawing up of a proposal for standardisation.

— The preparation of the comprehensive prior review of the participating countries' credit institutions, which is necessary from the legal standpoint for the ECB to assume supervisory responsibilities. This comprehensive assessment will include the identification and evaluation of general risk factors (the risk assessment system), an exhaustive balance sheet assessment and stress tests, the latter in conjunction with the EBA. The assessment of credit institutions' balance sheets is scheduled to begin towards the end of the year.

4.2 New consolidation accounting criteria

Historically, the resolution of accounting problems has been preceded by shortcomings and excesses during economic boom periods.

The crisis highlighted accounting practices for special-purpose vehicles

The crisis that broke in 2007 highlighted different practices for what are known as "special-purpose vehicles" (SPVs). These are structures created with pre-set functioning mechanisms that evidenced a lack of control by the sponsor, and which received liquidity facilities or other credit enhancements that enabled them to acquire high credit ratings, sometimes evading consolidation thanks to simplistic interpretations of accounting rules. These structures not only exposed sponsor institutions to risks relating to the credit enhancements granted, but also, once assets became impaired or liabilities could not be rolled over, it was the sponsors who took the burden upon themselves.

The FSB launched a recommendation for the improved accounting of off-balance sheet exposures…

Faced with this, in April 2008 the FSB called on accounting standard-setters (FASB and IASB) to improve the accounting of off-balance sheet exposures, by pushing through a process first initiated in 2003. The IASB released a draft definition of control in 2008, and IFRSs 10, 11 and 12 were finally approved in May 2011 for their application in 2013 (put back a year in the European Union).

… with the adoption of new accounting criteria

In accordance with IFRS 10, an entity controls another when it has the power to control its relevant activities, is exposed to variable returns and has the ability to influence returns from the investee.

The concept of controlling power is strengthened and broadened, and is not confined to financial and operating activities, but encompasses activities that are relevant for the entity. In this way SPVs that were previously consolidated exclusively because of exposure to risks and benefits will now be consolidated because they are controlled in exceptional but relevant circumstances, such as the management of loans in the event of default.

The exposure to variable returns, which is necessary for the existence of control and which means that the returns the entity obtains from the investee should be able to vary as a result of the latter's performance and not be fixed, is evidenced not only by rights typically associated with control, such as dividends, but also by commissions, or by returns from economies of scale.

The standard seeks to apply control criteria which, on the basis of certain principles, provide for the resolution of issues that were previously addressed without allowing for nuances. These include the consideration of potential voting rights, the consideration of control when a majority of voting rights is not held, the explicit introduction of the requirement that control criteria be reviewed, the treatment of control when voting rights are not the relevant issue or the development of the figure of the agent (he/she who acts for the benefit of a third party with delegated decision-making powers). The standard thus seeks to avoid the widespread practice of quantitative limits in respect of exposure to risks and benefits, which previously determined the existence of control or the absence thereof. It also includes detailed guidelines on aspects to be considered if no investor has more than 50% of the voting rights, such as the stake of the other shareholders or shareholder agreements. Regarding potential voting rights, the standard adopts a less rigorous criterion, reflecting economic rationality in respect of exercising the right, with the fact that the rights may be exercised not being definitive.

Another significant aspect of the modification is related to the importance of maintaining an internally consistent body of rules as a basis for a common and logical language. This reform achieves a single consolidation model (which is not dispersed across various rules) applicable to any type of institution in which an interest is held, be they institutions with voting rights or institutions in which voting rights are not a decisive factor in the existence of control.

The changes not only focus on improving the definition of control but also address another significant aspect: the information in the notes to financial statements (IFRS 12) on structures in which institutions have some type of interest, not necessarily in the form of a holding, but which are not consolidated. This would be the case of institutions sponsored by groups which do not have a holding, are not committed to providing any support but which remain concerned as it influences their reputation.

Finally, IFRS 11, which is applicable to joint arrangements, seeks to simplify matters by using only one method to record joint ventures.

According to the information disclosed by the listed companies, it is not estimated that amendments to the definition of control will have a significant impact on the consolidated statements of Spanish credit institutions. The purpose of this reform is not to introduce new criteria but for them to be applied homogeneously, avoiding financial structures which are controlled from being excluded from the scope of consolidation, at the same time as improving reporting to allow the assessment of risks to which they are exposed due to non-consolidated financial structures.

4.3 Review of the Financial Assistance Programme for Spanish banks

The fourth review of the financial assistance programme for Spanish banks took place from 16-27 September. As on previous occasions, a delegation from the European Commission, in liaison with the ECB, and accompanied by the EBA, the European Stability Mechanism and the International Monetary Fund, the latter in its role as programme monitor, met Spanish authorities, financial institutions and other private institutions.

The report will be published in mid-November. The main conclusion of the European and international institutions, as reflected in their public statements, is that the programme is moving ahead as envisaged.

Practically all the structural reforms of the financial sector have been accomplished, pending approval by Parliament of the Law on savings banks and bank foundations. Consequently, the framework of governance, regulation and supervision of the banking sector has been strengthened, enhancing its resilience in the face of potential future shocks.

The restructuring of institutions that have received assistance is progressing at a sound pace and the plans approved by the European Commission are being met under the latter's terms. The Spanish banking sector's liquidity situation and financing structure have continued to improve, against the background of progressively stabilising markets and access once more for Spanish banks to funding markets. Spanish institutions' solvency position remains comfortable following the recapitalisation of parts of the banking sector, the transfer of real estate-related assets to Sareb, and the improvement in results so far in 2013 compared with those in 2012.

Nonetheless, the broad economic setting advises maintaining close surveillance and supervision over the banking system, providing for sustained, proper diagnosis of the shock resilience and solvency of the Spanish banking sector to head off possible problems.

Lastly, the IMF recommends the adoption of pan-European policies, such as pushing ahead towards banking union and applying additional monetary policy measures.

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2 Moreover, it is updated daily in the Statistics section.
3 A quarterly update of the tables of this publication is also disseminated on the Internet.
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