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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
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
EPA	Official Spanish Labour Force Survey
ESFS	European System of Financial Supervisors
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
FSR	Financial Stability Report
FVC	Financial vehicle corporation
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
LGD	Loss given default
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
OTC	Over the counter
PD	Probability of default
PER	Price earnings ratio
pp	Percentage points
ROA	Return on assets
ROE	Return on equity
RWA	Risk-weighted assets
SCIs	Specialised credit institutions
SMEs	Small and medium-sized enterprises

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

SIV	Structured investment vehicle
SPV	Special purpose vehicle
TA	Total assets
TARP	Troubled Asset Relief Program
VaR	Value at risk
WTO	World Trade Organisation

CONTENTS

Since the publication of the last Financial Stability Report (FSR), the international financial system has – more intensely so since the start of the summer – seen tensions worsen notably. The main and intertwined factors behind this are the worsening of the sovereign debt crisis in the euro area, the funding difficulties facing banks and the deteriorating economic growth outlook.

The difficulties in designing a new aid programme for Greece prompted a heightening of instability on European financial markets in June and July. Doubts over sovereign debt markets were not confined to relatively small economies, but spread with intensity to other larger countries, Spain and Italy in particular. The seriousness of the situation led to the adoption of various agreements at the European summit of Heads of State or Government on 21 July, shortly after the publication of the European banking stress tests. Despite these measures, tension persisted and the European Central Bank reactivated its Securities Market Programme, while continuing to ensure European deposit institutions had access to liquidity.

As in other European countries, the sovereign debt crisis in the euro area has interacted negatively with the situation of the banking sector, substantially hampering access to medium- and long-term wholesale funding, as reflected in the low issuance volumes on wholesale markets. Against such a complex background, the process of recapitalisation of the Spanish financial system launched by Royal Decree-Law 2/2011 was finalised.

The aim of the recapitalisation of the banking sector was that all Spanish banks should have a core capital ratio of at least 8% (10% under certain circumstances). Those that did not meet the new minimum requirements had until 30 September to increase their capital, either through private investors or through the FROB. On 30 September the Banco de España reported on how matters had unfolded, reporting a contribution of €7.55 billion by the FROB and the raising of €5.84 billion of private capital, making for total additional capital of €13.39 billion for those institutions that have had to strengthen their capital to meet the new minimum regulatory requirements.

The persistence of the strains and the uncertainty over the euro area sovereign debt situation and the European banking sector led to new agreements at the European summit of EU Heads of State or Government on 26 October. These agreements are limited to three areas: (1) the search for a solution for the case of Greece that includes a voluntary acceptance by the private sector that amounts to a nominal discount of 50% on Greek debt; (2) the expansion of the European Financial Stability Facility (EFSF); and (3) a programme to recapitalise European banks that involves raising the Core Tier 1 capital ratio to 9% and marking to market all sovereign debt exposures.

In the difficult macro-financial environment prevailing since the publication of the last FSR, credit to the residential private sector in Spain continues on a declining course. This reduction in credit is not unrelated to the necessary adjustment in the level of indebtedness of some non-financial corporations and households, following the strong rise in such debt in the years prior to the crisis breaking.

The weak performance of the economy coupled with the continuing instability on financial markets make for an uncertain setting that might result in increases in bad debts on top of those already seen. In any event, the rise observed in the doubtful assets ratio has been particularly concentrated in real estate development activity, reflecting the impact of the severe adjustment in this sector. The information required by the Banco de España of banks to detail their exposure to real estate development activities shows that the coverage of problem exposure to this sector stood at 33% as at June 2011.

The medium- and long-term wholesale funding markets have remained practically closed. As a result, most European banks, like their Spanish counterparts, have scarcely made any issues over the past months. Unsecured money market activity in the euro area has also fallen off notably. Nonetheless, secured short-term financing activity through the central counterparty clearing houses has functioned normally. Furthermore, the Eurosystem has continued to ensure access to liquidity. Spanish banks' difficulties in gaining access to funding markets have been reflected in a fresh increase in recourse to Eurosystem financing, albeit with considerably less intensity than that recorded in the summer of 2010, when such recourse peaked.

Spanish deposit institutions continue to post positive rates of change for non-financial corporations' and households' deposits, in contrast to the attendant rate for credit extended. Should this pattern persist, it will partly alleviate borrowing needs on financial markets in the coming months.

The profitability of Spanish deposit institutions remains subject to certain pressures, deriving mainly from the high weight of asset impairment losses and the narrowing of the net interest margin. The latter is due to several factors which will tend to persist in the coming quarters, particularly sluggish activity, high financial costs and the sizeable amount of doubtful non-interest-earning assets. One key factor that might counter these elements bearing down on profits is the reduction in operating costs, something obligatory at institutions undergoing restructuring, and likewise advisable for all other financial institutions.

In conclusion, the current landscape in the euro area is one of financial tensions not witnessed since the Lehman Brothers crisis. It is the outcome of interacting and as yet unresolved tensions surrounding the sovereign debt crisis, the banking sector's ability to obtain funding and a bleaker economic growth outlook. This situation led to new agreements at the European summit of Head of State or Government on 26 October. Compounding the situation in Spain is the ongoing severe adjustment in the real estate development and construction sector.

In recent months the sovereign debt crisis has heightened, financial institutions' difficulties in obtaining wholesale funding have increased and the world economic growth outlook has worsened

Since the publication of the previous report, developments on international financial markets have been marked by a notable worsening of tensions and greater risk-aversion. These developments have been very closely tied to the deterioration and spread of the sovereign debt crisis in the euro area and to a bleaker growth outlook globally and, especially, in the US economy.

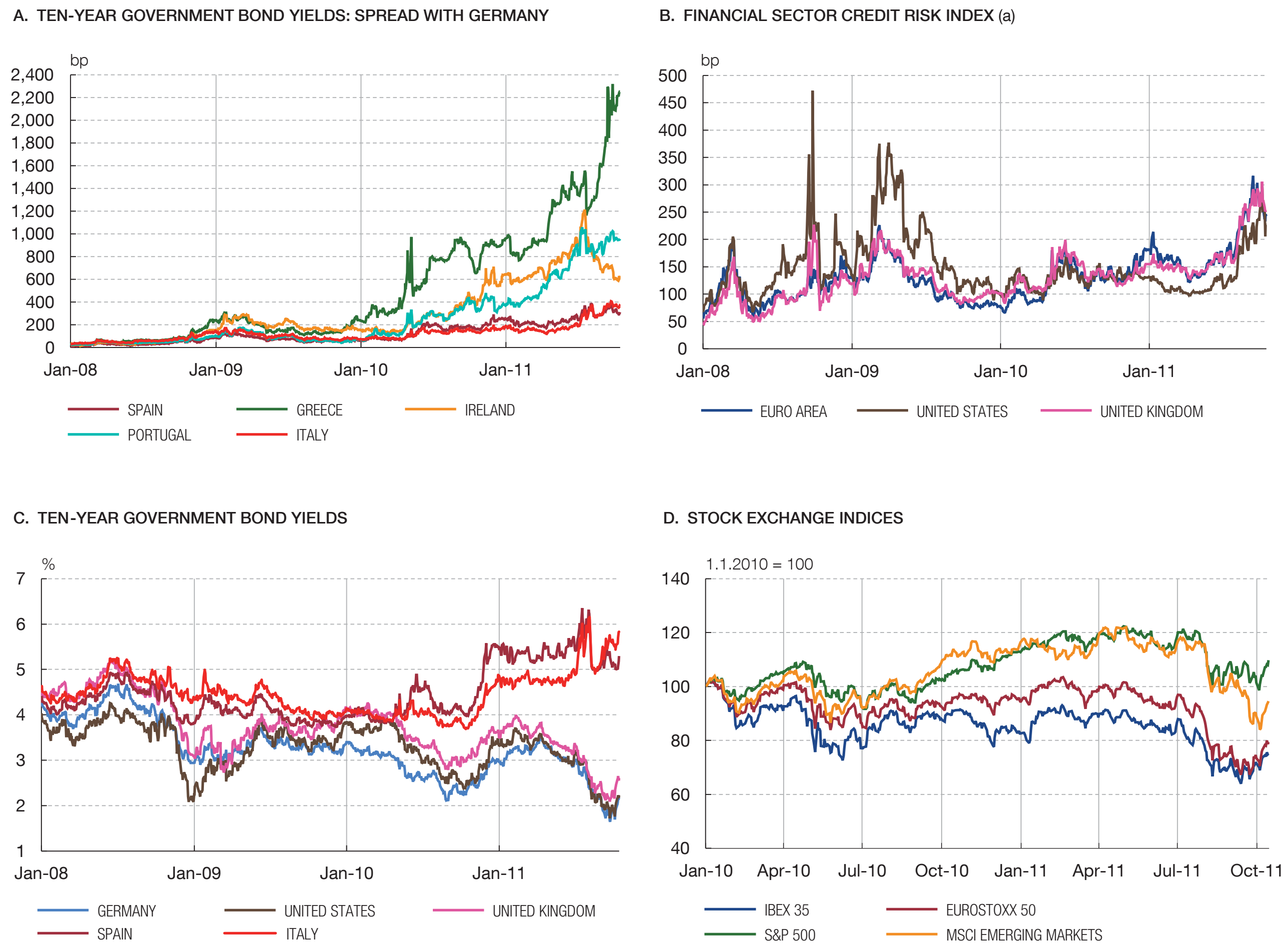
In the euro area, difficulties in agreeing on a new aid programme for Greece and, in particular, the debate over the participation of private investors in the programme prompted renewed turbulence in June and July, which particularly affected Spain and Italy. The instability continued despite the agreements reached at the European summit of Heads of State or Government on 21 July (which, along with a new support package for Greece, envisaged a broader set of measures to improve the sustainability of Greek debt and to curtail the risk of contagion; see Box 2.1). It only began to abate from the second week in August, following the ECB Governing Council's decision to reactivate the Securities Market Programme, extending it to Spanish and Italian debt, and the announcement of economic policy measures by the Spanish and Italian governments. Adding to the foregoing measures are those announced by the European Commission. In particular, and reflecting the difficulties European banks continue to face (difficulties intertwined with the sovereign debt crisis and with the weaker growth outlook), State aid for the bail-out and restructuring of credit institutions beyond 2011 has been extended, whereby such aid will be sustained under the same terms next year. Finally, the persistence of the macro-financial tensions led to the agreement of new measures by the European Heads of State or Government on 26 October (voluntary contribution by private creditors that amounts to a nominal discount of 50% on notional Greek debt, strengthening of the EFSF and recapitalisation of the European banking sector to achieve a Core Tier 1 ratio of 9% and marking to market of all its sovereign debt exposures; see Box 2.1).

The tensions were reflected in a further widening of yield spreads on sovereign debt within the euro area. During this period spreads reached an all-time high since the creation of the euro (close to 400 bp in the case of Spanish and Italian 10-year debt, although they fell subsequently, to stand at end-September at around 310 bp and 365 bp, respectively). The tensions spread to other markets, especially in Europe, but also in other developed and emerging economies (see Chart 1.1). Hence there was a rise in the credit risk premia on securities issued by financial institutions, whose share prices fell back and whose difficulties in obtaining funds on interbank markets – especially in dollars in the case of European banks – increased. The implied volatility of stock market indices rose, climbing in many cases to the levels of May 2010, when the Greek debt crisis broke. Overall, this shaped a complex setting for the wholesale funding of credit institutions.

Against this background, investors' search for safe assets and the gloomier economic outlook prompted a decline in yields on long-term debt in several developed economies, in particular the United States and Germany, to historically low levels. Moreover, some currencies such as the Swiss franc and the yen also acted as safe-haven assets in this period. Indeed, the strong upward pressures on these currencies led the authorities in both countries to intervene on the foreign exchange markets and to approve exceptional measures to check the appreciation of their currencies. The developments in the euro area led to a depreciation of the euro against the dollar, sterling and numerous emerging-

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: 14 October 2011.

economy currencies. As to commodities, Brent oil prices moved in a relatively narrow range (between $110 and $120 per barrel) despite the sustained political tension in various Middle East countries in a setting of relatively sluggish demand. Finally, gold also acted as a safe-haven asset and its price reached an all-time high close to $1,900 per ounce. More recently, the release of some less-negative-than-expected economic data in the United States coupled with some progress in resolving the European sovereign crisis prompted a partial reversal of the above-mentioned movements. This was reflected, among other aspects, in an increase in interest rates on high-quality long-term debt, a euro rally on foreign exchange markets and a fall-off in gold prices to close to $1,700 per ounce.

Fiscal challenges have not been confined to Europe but are being faced in numerous developed economies. Thus, for instance, the US difficulties in negotiations on raising the debt ceiling and the downgrading of its debt by a credit rating agency in August adversely influenced the markets. And in Japan, the cost of reconstruction in the wake of the earthquake and nuclear crisis in March have exerted further pressure on public finances.

Activity in the developed economies slowed in Q2 and the growth outlook for 2011 and 2012 has dimmed

Activity slowed in the first half of the year in the developed economies and, in particular, data released as from Q2 proved especially weak. The diminished momentum of activity, which is expected to have run into Q3 according to the leading indicators available, reflects anticipated and non-anticipated factors. The former include most notably the structural fragilities in the developed economies, the discontinuation of certain fiscal and monetary stimuli, and the inventory cycle. Among the non-anticipated factors are several negative supply-side shocks of a temporary nature (the Japanese earthquake and political problems in several oil-exporting countries that led to oil price rises) and the consequences of the financial turbulence. All told, the prospect of recovery in the developed economies is expected to be delayed, but not erased. The closing of the output gap is expected to be slow and not always smooth in a setting marked by a highly expansionary monetary policy, with certain new fiscal stimuli in the United States, even though a withdrawal of monetary and fiscal stimuli was projected some months back. The growth outlook for the industrialised economies has thus been revised downwards for 2011 and 2012 to around 2%, compared with the 3% increase recorded in 2010. Moreover, the downside risks to growth increased significantly. In this setting of concern over the weakness of growth and of limited policy headroom, the markets have discounted that official interest rates in the main economies will hold at very low levels for a relatively lengthy period (in particular, any rise before 2013 in the United States has been discounted).

At the same time, growth rates in the emerging economies remain high, albeit lower than in the preceding quarters

Meantime, the emerging economies have maintained high growth rates, although the pace of expansion has been diminishing, in line with the withdrawal of the monetary stimuli, the convergence towards potential growth rates and the lower growth of the developed economies. Indeed, the growth rate in these economies is expected to stand at around 6.5% in 2011 and 2012 compared with 7.3% in 2010, with the dichotomy between their behaviour and that of the developed economies remaining in place. Turning to prices, inflation in the developed economies appears to be beginning to slow, while inflationary pressures (along with other signs of overheating such as the high expansion of credit or the rising trend of asset prices) remain in some emerging economies. Notwithstanding, the central banks of these economies have decided to halt the cycle of official interest rate rises and in some cases (Brazil and Turkey) they have even cut rates in light of the greater uncertainty over the international setting.

In the euro area, economic activity also slowed, the short- and medium-term growth outlook has deteriorated somewhat and downside risks have increased

In the euro area, following a first quarter in which output expanded more than expected, economic activity slowed in Q2 as a result of the reversal of certain temporary factors that had boosted growth during the three previous months. Thus, GDP increased by 0.2% in Q2 in quarter-on-quarter terms and by 1.6% compared with the same period in 2010 (see Chart 1.2.A). The short- and medium-term outlook has deteriorated, as reflected by the downward revision of most analysts' and international organisations' projections, while downside risks have increased, linked above all to the persistence and worsening of tensions on financial markets. Specifically, the ECB's September projections show GDP growth in a range of between 1.4% and 1.8% for 2011 and between 0.4% and 2.2% for 2012, entailing lower rates in both cases than those in the March exercise.

In Spain, economic activity also slowed in Q2 and jobs continued to be destroyed, albeit at a lesser pace

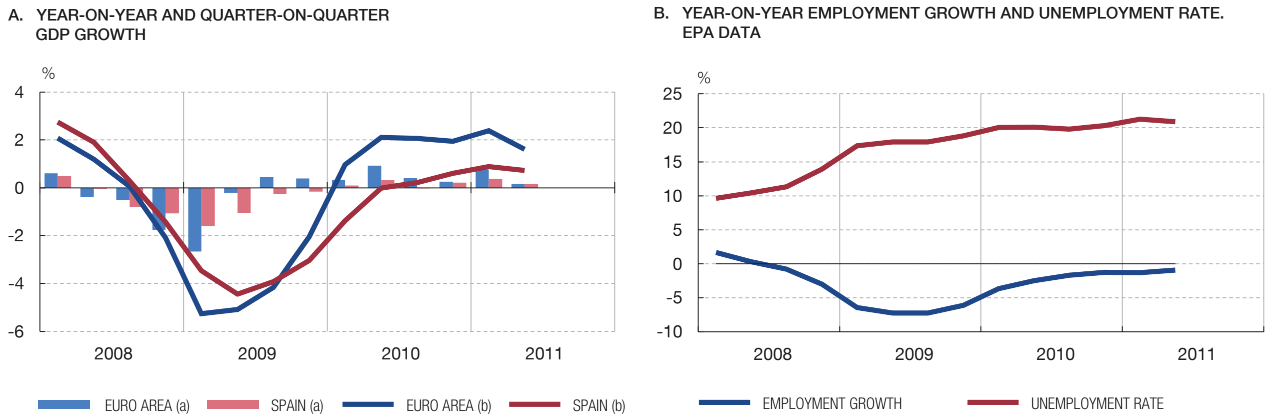
In Spain, economic activity also slowed in 2011 Q2. GDP growth was 0.2% quarter-on-quarter, compared with 0.4% in the three previous months, and 0.7% in year-on-year terms (see Chart 1.2.A). These developments were accompanied by continuing job destruction, albeit at a lesser pace (see Chart 1.2.B), placing the rate of decline in Q2 at 0.9% in year-on-year terms, 0.3 pp less than in the previous quarter. The indicators available for Q3 point to slack activity.

Private-sector debt in Spain remains high, while household wealth has continued falling and the rise in business profits has slackened...

The financial position of the private sector continues to be characterised by still-high debt ratios, although low interest-rate levels represent relief for the associated debt-service burden. The persistence of high unemployment rates tends to lessen the safety buffers available to indebted households to meet their obligations in this situation, while household wealth has continued declining as a result of the falls in property prices, which have

GDP AND EMPLOYMENT

CHART 1.2



SOURCES: INE, Eurostat and Banco de España.

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

steepened somewhat during the first half of the year, and of the declines in the value of financial assets. The information available on business profits (based on the data for the first half of the year from the sample of companies reporting to the quarterly Central Balance Sheet Data Office survey) shows a loss of momentum in ordinary profit.

...and general government debt is slowing but continues to grow in terms of GDP

General government debt has continued growing at a high though increasingly more moderate rate (15.4% in annual terms, in July). In combination with the sluggish growth of economic activity, this has continued translating into further increases in the debt/GDP ratio (65% of GDP in June) and in the debt-service burden (2.1% of GDP).

As a result, credit, market and liquidity risk have all risen

In short, the latest developments on financial markets and the latest data available on the conjunctural situation in the national and international economy and on the financial position of the various sectors point to an increase in credit, market and liquidity risk. And this against a background of high uncertainty in which the likelihood of adverse events materialising in the short- and medium-term has increased. This more complex situation has resulted in the Kingdom of Spain's credit rating being downgraded in the opening weeks of October. As is habitual following a sovereign downgrade, there will tend to be reductions in the rating of other securities – banks are a case in point – for which sovereign debt acts as a ceiling.

2 DEPOSIT INSTITUTIONS AND OTHER FINANCIAL MARKET PARTICIPANTS

2.1 Deposit institutions

2.1.1 BANKING RISK

Since the last Financial Stability Report (FSR) was published, the international financial markets have seen further bouts of tension and of withdrawal of investor confidence. The renewed uncertainties surrounding the sovereign debt crisis in the euro area, their interaction with the banking sector and the doubts as to the growth capacity of the world economy (particularly the United States and Europe) make for a very difficult environment and have prompted the new agreements reached at the European summit of Heads of State or Government on 26 October (see Box 2.1).

Spanish deposit institutions, immersed in this adverse scenario, made significant advances in restructuring the savings bank sector to meet the recapitalisation requirements laid down by Royal Decree-Law 2/2011 (see Box 2.2).

The **total consolidated assets**[1] of Spanish deposit institutions in June 2011 amounted to €3,82 billon (see Table 2.1).

Financing to the private sector continues to show negative rates of change

Financing to the private sector (credit plus fixed income) at consolidated level decreased by 3% in June 2011 with respect to the same period of the previous year (see Table 2.1). This is explained both by the decrease in private-sector securities and by the performance of credit, which showed a negative year-on-year rate of change of 2% (see Table 2.1). This performance of credit is explained by uncertainty over the economy and, as a result, over the credit quality of bank customers, which has led to a tightening of lending standards. In addition, the closure of the primary fixed-income markets in recent months to European banks is having adverse effects on credit developments. On top of these supply-side factors come the weakness of demand in an economic environment like the present one and – a more structural factor – the need to adjust the excessive indebtedness of non-financial firms and households.

Financing to general government (credit plus fixed income) at consolidated level grew by 14% in June 2011 with respect to June 2010 (see Table 2.1). This increase is sharper than that in December 2010, but lower than that of June 2010. In any event, its weight in the consolidated balance sheet of deposit-taking institutions is 10.6% (see Table 2.1).

The weight in the balance sheet of the public debt of the euro area countries subject to greatest tension is 0.4%

The stress test results published last July show that Spanish banks’ exposure to the general government debt of Greece, Ireland, Portugal and Italy amounts to 0.4% of total assets in December 2010 (see Chart 2.1.A). Spanish public debt held by Spanish institutions, which is naturally higher, has a relative weight of 6.9% in the sector’s consolidated balance sheet (see Chart 2.1.A). Taking the June 2011 figures for total Spanish deposit institutions in their business in Spain, it is seen that the financing granted by them to Spanish general government is concentrated (nearly two-thirds) in central government (see Chart 2.1.B).

1 Restructuring in 2010 reduced the number of banking groups, so that the first financial statements have updated starting balances. The consolidated balance sheets as at 30 June 2011 contain the aggregate figures of the banking groups at that date, which differ from those a year earlier. This should be taken into account also in analysing the consolidated income statements. In any event, these considerations should be taken into account when interpreting the figures in this FSR.

AGREEMENTS OF THE EURO AREA HEADS OF STATE OR GOVERNMENT AND OF THE INSTITUTIONS OF THE EUROPEAN UNION ON 21 JULY AND 26 OCTOBER

BOX 2.1

In the opening months of 2011, the European economic authorities acknowledged the impossibility of refinancing Greek debt on the markets in mid-2012 as envisaged in the initial aid programme. The difficulty in designing a new aid programme and the controversy over the participation of private investors heightened tensions in the sovereign debt markets in June and July, which spread strongly to Spain and Italy. The magnitude of these challenges obliged the Heads of State or Government of the euro area to hold an extraordinary meeting on 21 July. This meeting reached significant decisions in two respects. First, it established the size and characteristics of a second financial aid programme for Greece. The programme, which will be implemented in concert with the IMF and with the voluntary participation of the private sector, envisaged a reduction of loan interest rates and a lengthening of maturities, and these improvements were also included in the programmes in place for Ireland and Portugal. It should be noted that the Heads of State or Government are committed to limiting private-sector participation solely to Greece, where the circumstances are exceptional. Meanwhile, the other euro area countries reaffirmed their determination to honour their sovereign debt and make the required fiscal and structural adjustments. Second, a significant reform was introduced to enhance the operational flexibility of the current EFSF, following the raising of its effective financing capacity to €440 billion in March. This reform will also apply to the future European Stability Mechanism (ESM), which will replace the EFSF in mid-2013. In particular, these mechanisms have the power to act pre-emptively and to finance the recapitalisation of the financial system by granting loans to governments, including those of countries not subject to the programme, and to intervene in secondary debt markets if an ECB analysis recognises the existence of exceptional circumstances posing a risk to financial stability.

Despite these significant changes in the size and approach of the Greek aid programme and in the flexibility of the EFSF, debt market instability surged in the weeks following the decisions and spread strongly to Spain and Italy. This prompted the European Central Bank to reactivate its programme to purchase debt in the securities markets at the beginning of August. These operations helped to calm market tensions, although they did not prevent a fresh outbreak of turmoil in September. In the case of Greece, reform fatigue and the difficulties in pushing through the promised fiscal adjustment in an adverse macroeconomic setting, the evident reluctance by some governments to increase the aid and doubts as to the ultimate extent of private-sector participation continued to heighten uncertainty about the solvency of this economy. To add to these problems, a long time was taken to put into practice the decisions on the EFSF, which required parliamentary approval in some States, and there were criticisms that this fund was insufficient to deal with financial challenges on the scale that would arise if the most adverse scenarios materialised and it had to provide aid to larger economies.

In this respect, the summit of Heads of State or Government of the euro area countries held on 26 October saw significant headway in the design of a sufficiently comprehensive strategy to restore and strengthen the financial stability of the euro area. Although some details have yet to be resolved, the agreement addresses the main weaknesses identified and provides for ambitious action in four areas. First, headway has been made in the design of the second Greek financial aid programme, which moves further towards private-sector participation, with the objective of reducing government debt to around 120% of GDP in 2020. Second, arrangements are made to maximise efficiency in the use of EFSF funds, and procedures established to enable it to multiply its operating capacity by up to fivefold and thus act as an effective mechanism for halting contagion. For this purpose, two leverage options are considered which would not be mutually exclusive. The first consists of providing insurance or a partial guarantee for troubled Member States' new sovereign bond issues. The second involves the creation of a financial vehicle to attract investment from private and public financial institutions. Furthermore, cooperation with the IMF will be strengthened so as to boost the capacity of the EFSF. Thirdly, a plan has been drawn up to restore confidence in the banking sector through, on one hand, an EU-coordinated guarantee scheme for bank liabilities, to facilitate the medium and long-term funding of the sector, and, on the other, the recapitalisation of the principal banks, which will be required to have a Core Tier 1 capital ratio of 9% by June 2012. Lastly, the governments renewed the commitment to continue to adopt the necessary measures to ensure the sustainability of public finances and to encourage economic growth by observing approved fiscal targets and pushing through structural reforms.

The Heads of State or Government also agreed further advances in the reform of governance and integration in the euro area in order to enhance the economic convergence required within a monetary union. The euro area countries noted that the recent approval of the governance reform which began in 2010 was an important step in addressing some of the weaknesses detected in the institutional arrangements of the euro area. However, its definitive solution requires more resolute progress towards economic integration, which may require a limited reform of the Treaty on European Union.

As mentioned above, two agreements were reached on the banking sector: one on capital (establishing a mandatory capital buffer for banks) and another on term funding (in order to facilitate banks' access to said funding). The ultimate aim of these measures is to restore confidence in the European banking sector. Both measures have been designed and coordinated by the European Banking Authority (EBA).

Under the European bank recapitalisation scheme approved, banks will have to maintain a temporary capital buffer. This capital buffer is a combination of two elements: the first is raising the minimum capital requirement to a Core Tier 1 ratio of 9%, as defined by the EBA; and the second is the valuation at market prices of general government debt instruments in accordance with the established methodology.

AGREEMENTS OF THE EURO AREA HEADS OF STATE OR GOVERNMENT AND OF THE INSTITUTIONS OF THE EUROPEAN UNION ON 21 JULY AND 26 OCTOBER (cont'd)

BOX 2.1

The capital needs published by the EBA on 27 October amount to €106,447 million for the group of banks considered in Europe. This is an estimate because it has been calculated on the basis of the data as at June 2011, although the amount of capital finally required to meet the criteria described above will be calculated taking the data as at September 2011. The EBA has published an estimate for Spanish banks of €26,161 million, which affects five banks. These banks have been respectively informed of the estimate. Their initial assessment is that they have the capacity to comply with the new requirements without the need for the public sector to take a stake in their capital. The Banco de España considers that these targets can plausibly be reached, and without prejudice to the banks submitting a detailed study of their specific plans to the Banco de España before year-end.

Under the European agreement this new capital buffer must be in place by 30 June 2012 at the latest. Banks must detail their plans for meeting this requirement by the end of 2011, which must be agreed with national supervisors, the Banco de España in the case of Spain, and coordinated by the EBA.

Finally, as mentioned above, the second element in the package of measures to restore confidence in the banking sector relates to the medium- and long-term debt issues of financial institutions. This is so European banks regain access to the primary markets for medium- and long-term instruments, to avoid credit restrictions operating through this channel next year. To this end, an EU-coordinated scheme is being designed to set up guarantees for issues by financial institutions. The EBA, ECB, European Commission and the European Investment Bank are committed to pressing ahead on this matter.

Consolidated total doubtful assets grew by 19% in June 2011

Total doubtful assets at consolidated level quickened to a year-on-year rate of 19% in June 2011 (see Table 2.1). This growth rate is higher than in December 2010 (14% year-on-year). As a result of the increase in consolidated total doubtful assets, the consolidated total doubtful assets ratio has risen by 78 basic points (bp) since June 2010 to 4.55%.

The primary securities markets remained practically closed for European institutions

The wholesale funding markets have been subject to tensions derived from the lack of investor confidence associated with the sovereign debt crisis in the euro area, which tended to intensify and spread to other countries in summer 2011. European financial institutions have found it difficult to access the primary markets, as have Spanish institutions. This is reflected in the behaviour of subordinated debt and of marketable securities, both of which recorded negative rates of change in June 2011 (see Table 2.1)

In a context in which the euro area money markets have experienced a notable setback, the European central counterparty clearing houses have continued to play a significant complementary role as source of traditional interbank financing. This is reflected, in Table 2.1, in a sharp increase in the liability heading "Other", which is typically residual, but now reflects the sharp increase in these operations through the central counterparty clearing houses.

The Eurosystem has continued to ensure access to liquidity

The **Eurosystem** has continued to ensure access to short-term funding and, at the same time, given the difficulties of some European institutions in raising short-term dollar-denominated funding, has taken additional measures to provide short-term funds in that currency. The funds raised by Spanish institutions in the Eurosystem amounted, in net terms, to a daily average of €69,299 million in September. This amount, although high compared with previous months, is still far from the peak reached in summer 2010 (daily average of €131,891 million in July 2010), and represents 1.8% of the consolidated assets of deposit institutions as a whole (see Table 2.1). If the difficulties persist, Spanish institutions have collateral for accessing Eurosystem liquidity.

CONSOLIDATED BALANCE SHEET.
DEPOSIT INSTITUTIONS | **TABLE 2.1**

Assets	Jun-11	Change Jun-11/Jun-10	Relative weight Jun-10	Relative weight Jun-11
	(€m)	(%)	(%)	(%)
Cash and balances with central banks	136,244	24	2.9	3.6
Loans and advances to credit institutions	207,578	2	5.3	5.4
General government	99,992	18	2.2	2.6
Other private sectors	2,361,503	-2	62.5	61.8
Debt securities	507,123	-2	13.3	13.3
Other equity instruments	57,371	-9	1.6	1.5
Investments	52,062	9	1.2	1.4
Derivatives	155,917	-26	5.5	4.1
Tangible assets	53,618	8	1.3	1.4
Other (a)	187,723	16	4.2	4.9
TOTAL ASSETS	**3,819,131**	**-1**	**100**	**100**
MEMORANDUM ITEMS				
Financing to private sector	2,478,803	-3	66.2	64.9
Financing to general government	406,403	14	9.2	10.6
Total doubtful assets	144,407	19	3.1	3.8
Total doubtful assets ratio	4.55	77 (c)		
Provisions for bad debts and country risk	-84,321	13	-1.9	-2.2

Liabilities and equity	Jun-11	Change Jun-11/Jun-10	Relative weight Jun-10	Relative weight Jun-11
	(€m)	(%)	(%)	(%)
Balances from central banks	87,536	-49	4.5	2.3
Deposits from credit institutions	514,037	3	13.0	13.5
General government	98,020	9	2.3	2.6
Other private sectors	1,818,879	1	46.7	47.6
Marketable debt securities	550,260	-5	15.0	14.4
Derivatives	145,425	-22	4.8	3.8
Subordinated debt	97,181	-6	2.7	2.5
Provisions for pensions, tax and other	34,340	1	0.9	0.9
Other (a)	248,680	53	4.2	6.5
TOTAL LIABILITIES	**3,594,358**	**-1**	**94.1**	**94.1**
MEMORANDUM ITEMS				
Eurosystem net lending (b)	69,299		3.3	1.8
Minority interests	17,599	23	0.4	0.5
Valuation adjustments relating to total equity	-8,152	n.s.	-0.1	-0.2
Own funds	215,327	-1	5.6	5.6
TOTAL EQUITY	**224,773**	**-2**	**5.9**	**5.9**
TOTAL LIABILITIES AND EQUITY	**3,819,131**	**-1**	**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. Septembert 2011 data.
c Difference calculated in bp.

Credit to the resident private sector continues to show negative rates of change

Credit to the resident private sector in Spain showed, on individual financial statement figures,[2] a decrease of 2.8% in June 2011 with respect to the same period of the previous year (see Chart 2.2.A). The trend of the last few months has steepened. The slowdown in credit to the private sector is fairly general across institutions

2 The FSR uses consolidated data, which include the foreign operations of Spanish institutions through their subsidiaries, but it also uses other data drawn from individual balance sheets. The latter, the use of which is indicated in the text and in charts (by the abbreviation ID), allow us to focus our analysis on the risks associated with the behaviour of the Spanish economy and to offer a more detailed analysis due to the greater information available.

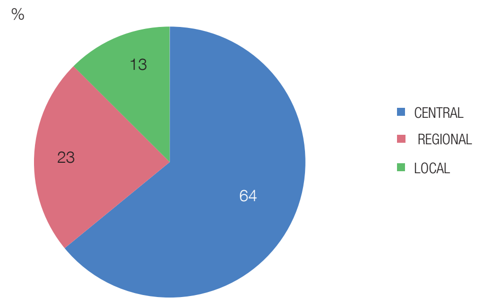
EXPOSURE OF THE SPANISH BANKING SECTOR TO DIFFERENT COUNTRIES' SOVEREIGN DEBT. Deposit institutions.

CHART 2.1

A. EXPOSURE TO DIFFERENT COUNTRIES' GENERAL GOVERNMENT DEBT. DECEMBER 2010

	€m	% total assets
Greece	448	0.01
Ireland	79	0
Italy	7,408	0.22
Portugal	5,492	0.16
Spain	231,696	6.91

B. BREAKDOWN OF SPANISH GENERAL GOVERNMENT EXPOSURE TO DEBT. JUNE 2011

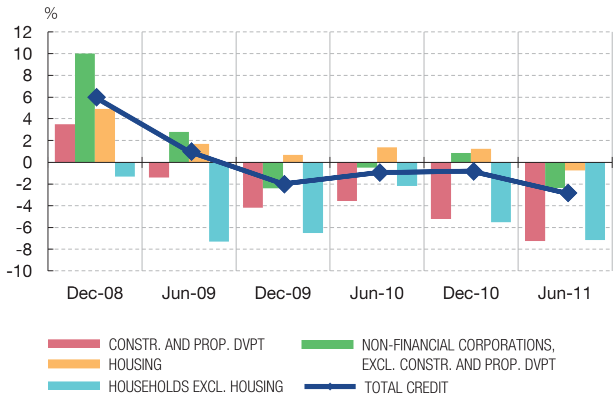


SOURCES: EBA stress tests and Banco de España.

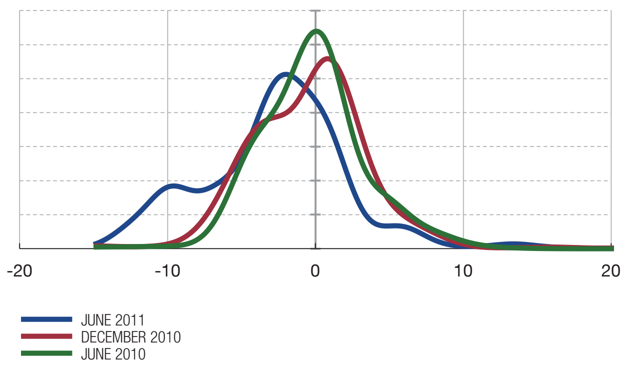
CREDIT TO THE RESIDENT PRIVATE SECTOR. Business in Spain, ID. Deposit institutions

CHART 2.2

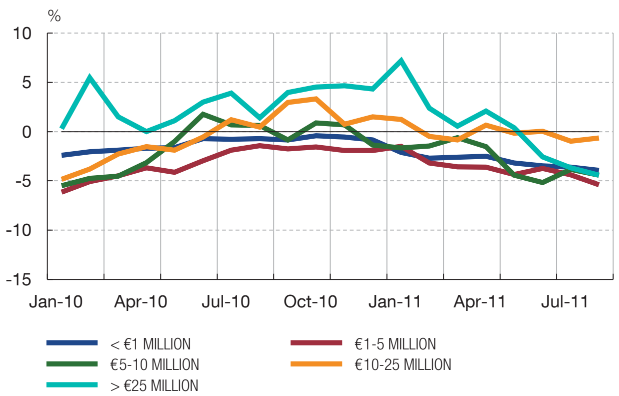
A. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR



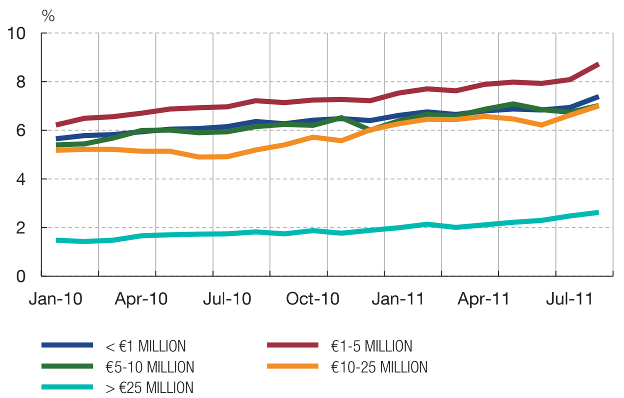
B. DISTRIBUTION OF CREDIT BASED ON ITS YEAR-ON-YEAR RATE OF CHANGE (%)



C. YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO NON-FINANCIAL CORPORATIONS, EXCL. CONSTR. AND PROP. DVPT BY CORPORATION SIZE (a)



D. DOUBTFUL ASSETS RATIO OF CREDIT TO NON-FINANCIAL CORPORATIONS, EXCL. CONSTR. AND PROP. DVPT BY CORPORATION SIZE (a)



SOURCE: Banco de España.

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

and, at the same time, the degree of dispersion between them has increased (see Chart 2.2.B). These credit developments reflect a lower supply of credit, because the economic uncertainty has caused institutions to tighten their lending standards and because the primary fixed-income markets have been closed in recent months to European institutions.

RESTRUCTURING OF THE SAVINGS BANKS SECTOR: THE RECAPITALISATION OF ROYAL DECREE-LAW 2/2011 BOX 2.2

Since publication of the last edition of this report, the process of restructuring the savings bank sector, in order to comply with the requirements of Royal Decree-Law 2/2011, has speeded up.

This Royal Decree-Law (RD-L) raised the solvency requirements for credit institutions in two ways:

- By creating a new capital requirement based on the concept of "core capital" contained in the new Basel III capital accord, which includes the higher quality elements of capital.
- By increasing the required levels of solvency to 8% for core capital for all institutions, a percentage that rises to 10% in certain specific cases.

By applying this legislation, the Banco de España identified a group of banks that did not initially meet the core capital requirements. These were required to submit strategic plans for meeting the required level of solvency before 30 September 2011. 13 institutions were identified, 9 of which were savings banks, and they chose various recapitalisation strategies, which are summarised as follows:

- Four groups of savings banks (Bankia, Cívica, BMN and Liberbank) decided to propose a private solution as their preferred option to cover their initial shortfall, either through IPOs or through the incorporation of external investors.
- One savings bank (CEISS) decided to undertake an integration process with another institution that had excess core capital, so that in the consolidated accounts for both institutions the shortfall initially incurred by the former could be offset.
- Four savings banks (Catalunya Caixa, Unnim, Nova Caixa Galicia and CAM) decided that they preferred to receive greater or lesser amounts of funds from the Fund for the Orderly Restructuring of the Banking Sector, which would again act as capital supplier of last resort.

All these strategies were supposed to be introduced before 30 September, although RD-L 2/2011 had envisaged that the Banco de España could grant extensions when certain conditions were met.

The situation of the restructuring process when this period expired can be summarised as follows:

- Two savings banks (Bankia and Banca Cívica) successfully completed their IPOs in July, raising the necessary capital (€3.09 billion and €600 million) to allow them to comfortably exceed the 8% level of core capital (9.2% and 9.7% respectively).
- Two institutions had an extension of 25 days to reach the required level of core capital. During this period they resolved the situation as follows: Liberbank opted to generate the necessary capital internally and BMN issued €242 million of convertible instruments with voting rights.
- CEISS has agreed to merge with Unicaja, without needing assistance from the FROB since the resulting institution will have a core capital ratio of more than 10%.
- As regards institutions that were basically going to depend on FROB funds, it is worth mentioning that:
  - CAM, at the request of its board of directors was taken under the control of the Banco de España. As a consequence, the FROB was appointed a director of the new institution, which is being restructured with a view to its sale through a competitive bidding process. For this purpose the FROB agreed to inject €2.8 billion of capital, and to provide a €3 billion liquidity facility.
  - The other three institutions (CatalunyaCaixa, Nova-CaixaGalicia and Unnim) have received funds from the FROB, to increase their core capital to more than 10%, totalling €4.75 billion (€1.72 billion, €2.47 billion and €568 million, respectively). According to the assessments made by the experts independently appointed by the FROB, the latter has become the majority shareholder in these three institutions (holding 100% of the capital in the case of Unnim).

Thus, the process of recapitalising credit institutions that had a shortfall of core capital when the new solvency obligations introduced by Royal Decree-Law 2/2011 of 18 February 2011 entered into force is being completed, with the contribution of €7.55 billion of funds from the FROB.

The difficult economic environment also weakens demand, resulting in the necessary correction of private sector indebtedness following its notable increase during the prolonged period of economic growth and credit expansion in Spain prior to the crisis.

Although the downward trend in credit is across the board, differences remain between the various sectors of activity...

The fall in credit to the resident private sector is also across the board in the various sectors of activity, although significant differences between them persist (see Chart 2.2.A). Thus lending to individuals decreased in June 2011 by 1.9%, and the fall was concentrated mainly in lending for purposes other than house purchase, where negative year-on-year rates of change of 7% were reached. Lending to individuals for house purchase in June 2011 showed a slightly negative rate of change, after positive rates in previous quarters, which in 2010 were at least partly attributable to the increase in demand derived from the bringing-forward of purchase decisions to the end of that year for tax reasons.

Credit to non-financial corporations exhibits, within the general pattern of decline in this variable, persistent notable differences between that to construction and real estate development firms and that to other firms. The former shows negative rates of change which reach 7.2%, continuing a process which began in early 2009 (see Chart 2.2.A).

…and not so much based on company size approximated by volume of bank debt

Credit to other non-financial corporations returned to negative rates of change similar to those seen in December 2009, posting a year-on-year fall of 2.3% in June 2011. If firm size is approximated by the volume of bank debt they report to the Banco de España Central Credit Register, and the degree of dependence of each firm on this type of financing is ignored, it is observed that the reduction in credit to other non-financial corporations also extends across all size classes (see Chart 2.2.C). The doubtful assets ratio, except for larger firms, is also similar across firms of different size classes (see Chart 2.2.D).

The higher rate of increase of doubtful assets is linked to construction and real estate development loans

Doubtful assets arising from credit to the resident private sector in business in Spain rose by 24.9% in June 2011 with respect to June 2010. The upturn in the growth of doubtful assets is explained by that derived from credit to construction and real estate development firms (see Charts 2.3.A and B). For other non-financial firms the rate of increase (13.8% in June 2011) is lower than in June 2010 (30%), while for households, both in home loans and in other credit, the rates of change in June 2010 remain negative, as in recent quarters (-3.1% and -10.1%, respectively).

The doubtful assets ratio of the resident private sector in business in Spain has increased…

The increase in doubtful assets and the negative rates of change of credit explain the rise in **the doubtful assets ratio of the resident private sector in business in Spain** (see Chart 2.3.C), which was up by 6.8% in June 2011 (7.2% in August 2011, the latest available figure). This increase in the doubtful assets ratio is across-the-board in deposit institutions (see Chart 2.3.D). The sluggishness of the economy and the persistence of problems in the economic and financial arena might result in additional rises in the doubtful assets ratio.

Sectoral analysis shows that the doubtful assets ratio for households (3% in June 2011) has held basically steady in the past twelve months, dropping slightly in loans for house purchase (2.44% in June 2011, against 2.5% a year earlier) and in loans for other purposes (5.9% in June 2011, against 6.1% in June 2010).

… this development being concentrated in construction and real estate development loans

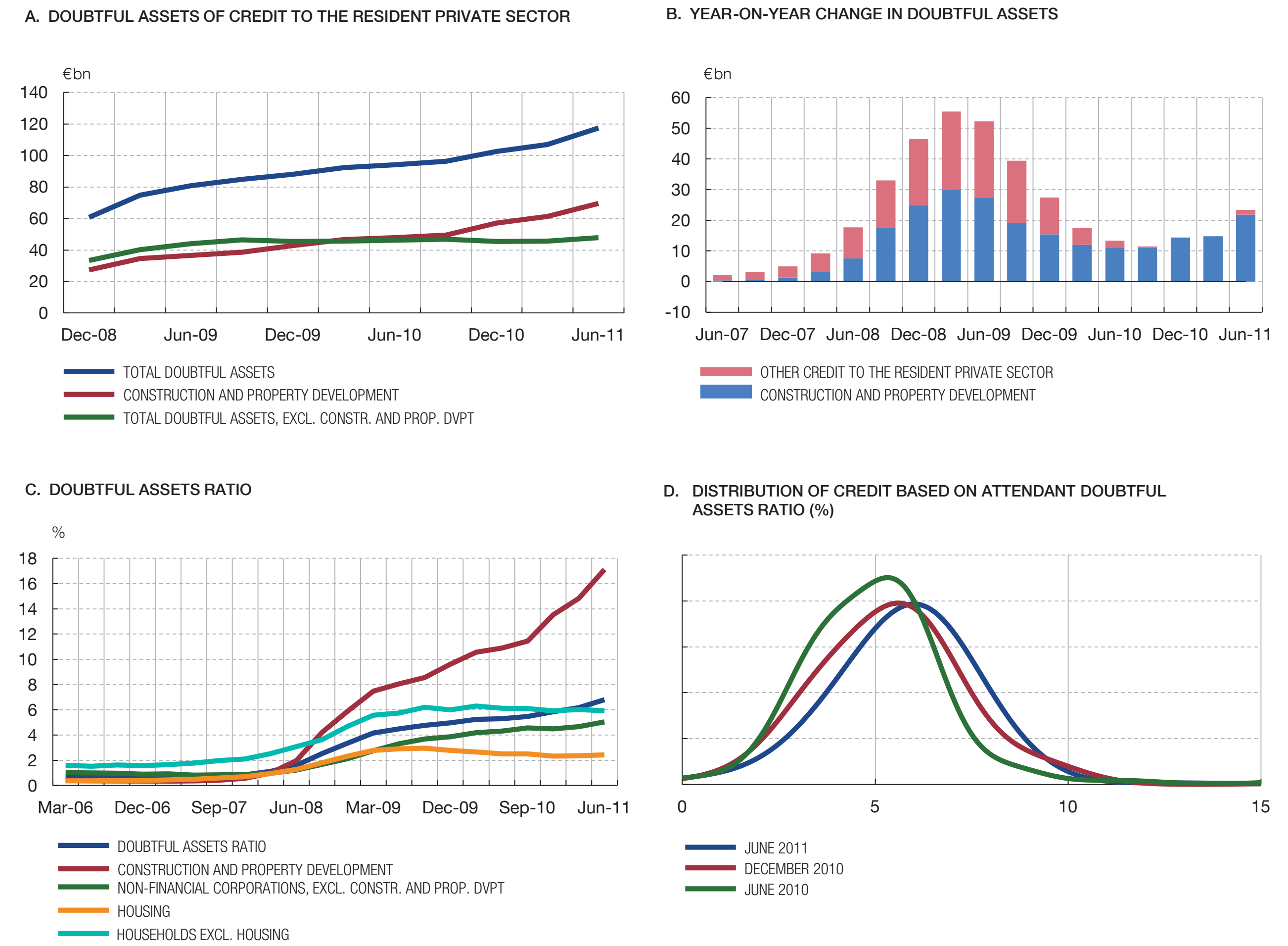
For non-financial corporations the doubtful loans ratio increased slightly in lending to companies other than construction and real estate development firms (5% in June 2011 against 4.3% in June 2010) and significantly more sharply in lending to construction and real estate development firms, for which the doubtful loans ratio in June 2011 stood at 17.1% (10.9% a year earlier).

At a time of marked adjustment in the real estate sector, the banking sector's troubled exposure is not limited to doubtful assets. Account must also be taken of foreclosed assets, assets received in satisfaction of debt and standard loans under surveillance.[3]

3 Loans current in payment but showing some weakness associated with the transaction itself or with a certain sector or group of borrowers.

DOUBTFUL ASSETS OF THE RESIDENT PRIVATE SECTOR. BUSINESS IN SPAIN, ID. DEPOSIT INSTITUTIONS

CHART 2.3



SOURCE: Banco de España.

The assets so classified, along with those considered to be doubtful, are subject to provisioning in accordance with the accounting rules of the Banco de España.

Moreover, the Banco de España has also required Spanish credit institutions to publish this information in detail. They must disclose it in their annual accounts and in any interim financial information they may make public.

The potentially troubled exposure to the real estate development sector represents 11.4% of the credit portfolio…

Based on this interim information,[4] the data relating to June 2011 indicate that the troubled exposure (doubtful assets, foreclosures and standard loans under surveillance) linked to real estate development amounts, for commercial banks and savings banks,[5] to €176 billon, i.e. 52% of the total exposure to real estate development. This volume of troubled exposure represents 11.4% of the credit portfolio (credit to the resident private sector in business in Spain, including, for this purpose, foreclosed assets) and 5.2% of consolidated assets (see Chart 2.4.A).

4 The information reflected in the FSR may differ to some extent from that published by institutions because the former includes credit drawn down, financial guarantees and 50% of undrawn credit. In the case of foreclosed real estate, the FSR states the book value of the credit immediately before the foreclosure or acquisition. Note also that, as explained on various occasions, the total of the exposure is based on the credit purpose criterion and thus does not coincide with the amount of credit for construction and real estate development stated in the *Boletín Estadístico* under the criterion of principle activity of the firm. Thus, for example, financing to large Spanish construction companies for the performance of other services or for large-scale infrastructure construction is not reflected in the figures reported in this FSR.

5 The figure relates to the institutions subjected to EBA stress testing in July.

… and the coverage by provisions already in place is 33%

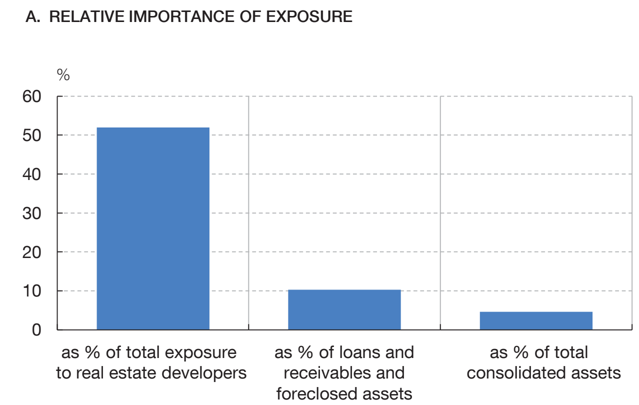
Coverage by provisions (specific provisions associated solely with these assets and general provisions for business in Spain) amounts to 33% of the troubled exposure in June 2011. This level of coverage of real estate development risk exposure means that the hypothetical losses under the baseline scenario of the European stress tests conducted by the EBA would be more than covered (see Box 2.3 on these tests). Under the adverse scenario, the probability of occurrence of which is very low, 88% of the hypothetical losses on real estate development and foreclosed loans would be covered by provisions already in place (those for real estate development loans and the general provision for business in Spain) (see Chart 2.4.B). Under the baseline stress scenario this coverage would exceed 120%.

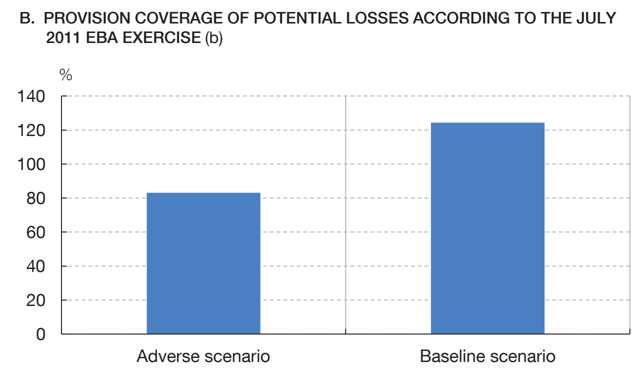
The total balance sheet write-offs by Spanish institutions since the commencement of financial system restructuring until June 2011 amount to €105 billon, equivalent to around 10% of GDP.

The financial markets have reflected new and more serious bouts of tension…

The international **financial markets** reflect renewed and more serious bouts of tension and risk aversion. This is a consequence of the exacerbation and spread of the euro area public debt crisis (see Charts 2.5.A and B) and of its interrelationship with the banking sector.

POTENCIALLY TROUBLED EXPOSURE TO THE PROPERTY DEVELOPMENT SECTOR. JUNE 2011 **CHART 2.4**
Business in Spain. Deposit institutions (a)

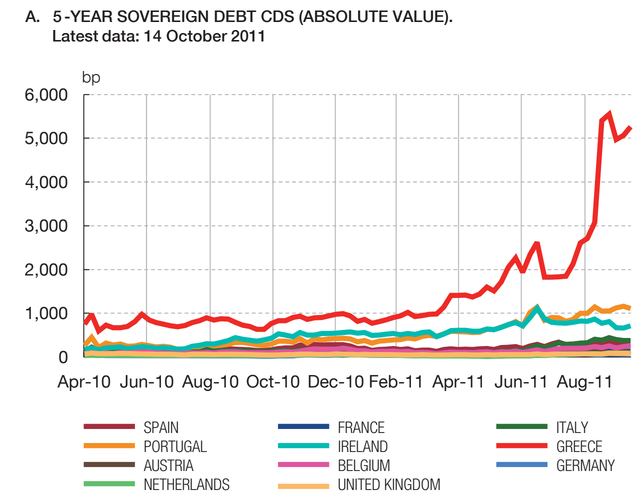


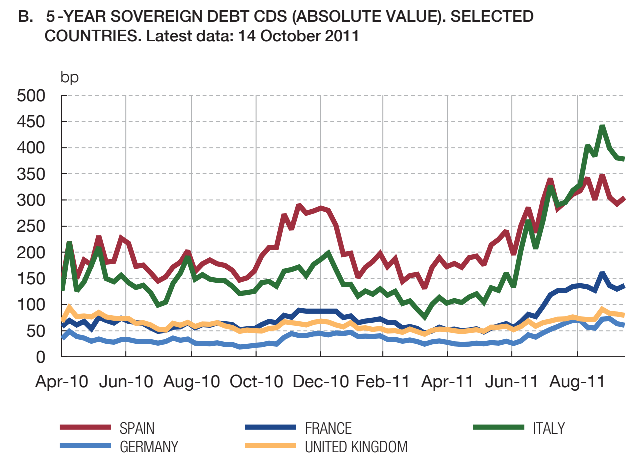


SOURCE: Banco de España.

a Includes all institutions that participated in the EBA stress tests.
b Specific provisions associated with real estate developer risk and general provisions of business in Spain.

CDS **CHART 2.5**





SOURCE: Datastream.

The results of the **2011-2012 stress tests conducted at EU level** were published on 15 July. The testing was coordinated by the European Banking Authority (EBA) acting in concert with the European Commission and the ECB and was carried out in 21 EU countries on a total of 91 credit institutions. The methodology of these tests is based on that which was used, also at the European level, in 2010. However, in order to overcome the doubts that arose barely a few months after the publication of the results of the 2010 exercise, and also because of the tensions relating to the European sovereign debt crisis, the 2011 tests incorporate significant changes. Four aspects should be noted: (1) the stricter methodology; (2) the higher level of capital – and its greater quality – following the stress; (3) the unprecedented degree of transparency; and (4) the intense process of review and homogenisation by the EBA.

As in the previous year, the Spanish banking sector was subjected to testing which was characterised by total transparency, since it included all Spanish savings banks and listed commercial banks. This signified a **coverage** of **93%** of the system, well above the 50% required by the EBA. Moreover, the commitment to transparency was met by publishing **additional information.** This additional information included a breakdown of hypothetical gross impairment losses by portfolio, presenting separately mortgage risk and real estate development risk.

The stress testing **methodology** used this year is stricter than in 2010, particularly regarding the cost of bank funding and minimum capital requirements. As regards the former, banks have had to face sharply **higher funding costs** due to the upward shift in the interbank rate curve and the pass-through of the increase in the sovereign spread. Regarding **capital requirements,** the minimum was set at 5% Core Tier 1 (CT1), much higher than the current core capital requirements in the European Union (2%) and than those of Basel III in the year of its entry into force (4.5%), which moreover do not include items with a high capacity to absorb losses (such as, for example, mandatory convertible debt).

The **stress test period** starts at the end of the 2010 accounting year. Impairment losses arising thereafter under a stressed scenario are calculated for the two-year period of 2011-2012 under the two scenarios designed for European testing: baseline and adverse.

Specifically, the **adverse scenario** is that in which Spanish GDP falls by 1% in 2011 and a further 1.1% in 2012. The probability of occurrence of the adverse scenario in Spain is lower than 0.5% in both years. The scenarios applied for Spain were also more severe than the European average in respect of real estate price behaviour, increase in risk premium and fall of the main stock market indices.

The information presented by the Banco de España, both bank by bank and grouping by grouping, included a breakdown of the hypothetical gross impairment losses in the main credit portfolios, detailing the items which absorb those losses up to the final impact on CT1. Additionally, results were presented which took into account other loss-absorbing items, paying special attention to general provisions. For the aggregate of the total system under the stressed adverse scenario, the main results, which show the solidness of the Spanish banking sector, are summarised below:

- The hypothetical asset impairment losses which would arise in 2011 and 2012 would amount to €168,811 million, representing 5.4% of total assets (6.5% for savings banks).

  The most significant source of these impairment losses was the credit portfolio, with €159,176 million, and, within it, the real estate development portfolio (€65,900 million, 39% of total credit risk impairment losses).

- Accumulated specific provisions would be able to absorb 39% of that impairment, while the generation of funds would serve to absorb an additional 47% (13% in savings banks and 90% in internationally active banks), even assuming a decrease in average net operating income with respect to 2010 (particularly severe, at 49%, in savings banks, which must be added to that of 40% already recorded in 2010).

- The CT1 at December 2010 was €139,863 million for total banks, giving a ratio of 7.4% (7.3% for savings banks). Stressed CT1 own funds at December 2012 would drop to €130,063 million (ratio of 6.5%) for total banks and to €33,727 million (ratio of 4.2%) for savings banks. On aggregating the €14,471 million of capital under Royal Decree-Law 2/2011 and the 2011 capital increases, stressed CT1 would rise to €144,534 million (ratio of 7.3%) for total banks and to €47,651 million for savings banks (ratio of 5.9%), which confirms the effectiveness of Royal Decree-Law 2/2011 for the solvency of Spanish banks.

- Under the adverse scenario, **five Spanish banks would not initially meet the minimum capital threshold of 5%** and would need additional capital of €1,563 million. However, if the €17,573 million of general provisions at December 2010 are taken into account, only one Spanish bank would initially lie below this threshold (CT1 ratio of 8.1%). If, in addition, the €5,147 million of compulsory convertible debt is taken into account, **no Spanish bank would lie below this CT1 ratio of 5%,** obviating the need to adopt additional support measures. Finally, after taking into account the other loss-absorbing items, **the final CT1 ratio for total Spanish banks would stand at 8.6%.**

The stress tests show that no Spanish bank needs to increase its capital thanks to the loss-absorbing items envisaged in our financial system, such as general provisions and compulsory convertible debt. If these funds are subtracted from bank balance sheets, five Spanish banks would not meet the minimum Core Tier 1 requirement of 5% set for these tests. The results are consistent with the analysis and the actions taken in the process of Spanish credit institution restructuring. The bank recapitalisation required by Royal Decree-Law 2/2011 was the last step in the restructuring process initiated three years ago in Spain, which has allowed balance sheets to be cleaned up, banks to undergo a concentration process, the corporate model to be changed through the transfer of nearly all savings bank activity to commercial banks, and corporate governance to be improved.

The negative growth outlook in different areas, including Europe and the USA, also contributes negatively to a very difficult environment in which European and Spanish credit institutions have to operate.

… with the primary wholesale funding markets practically closing in Europe

These factors have shaped a scenario in which, from summer to the present, **issuances** by euro area financial institutions have been scant. The medium- and long-term wholesale funding markets, even for collateralised securities like covered bonds, have remained practically closed. In this difficult environment Spanish deposit institutions have not issued securities in the medium- and long-term wholesale markets. Although the maturities of wholesale funds are relatively evenly spaced over the next few years (see Chart 2.6.A), the persistence of the financial market difficulties is a cause for concern in the Spanish banking sector.

Short-term funding has also been subject to renewed tension...

Short-term funding has been subject to renewed tension. Short-term dollar-denominated funding has recently come under pressure, as a result of structural changes to US money market funds and the scant appetite for European risk in the US market. This pressure has adversely affected the European institutions most exposed to this type of funding and, indeed, prompted action by the European Central Bank in concert with other monetary authorities to palliate these tensions (see Box 2.4). This situation has not affected Spanish institutions, since their dependence on this market was already very limited.

The euro area money markets also fell notably. This is evidenced by the Eonia trading volumes which, after recovering in the third quarter of 2010, have seen a particularly sharp drop in the average amount traded since the second quarter of the year (see Chart 2.6.B). In the Spanish market, although the unsecured segment of the interbank market (that most affected by the crisis) also suffered a slight setback at the end of 2010, the first quarter saw a significant recovery which, however, lost steam in the second quarter and worsened still further in the third quarter. Thus, while average daily trading in this segment was €5,280 million in the first quarter of 2011, in mid-September the average recorded for the third quarter (before it had ended) was €3,527 million. The repo segment continued to hold fairly steady, with slight variations due to the transfer of activity from the unsecured segment. In this respect it should be noted that European central counterparty clearing houses have continued to play a significant role as an alternative source of interbank financing to the traditional market.

… which is reflected in the increased recourse to Eurosystem financing,…

Simultaneously with the greater difficulty in raising funds on the euro area money markets, there was an increase in total recourse to Eurosystem liquidity (see Chart 2.6.C). For Spanish institutions this meant that from end-February to end-September 2011 the institutions resident in Spain raised their gross recourse to the Eurosystem by €31,280 million (up 64%), while the outstanding balance in the Eurosystem as a whole increased by €145,995 million (up 33%, see Chart 2.6.C).

RECENT EUROSYSTEM MEASURES

BOX 2.4

Against the background of renewed tensions on European financial markets due to the worsening of the sovereign debt crisis, the Eurosystem has adopted various measures in recent months aimed at facilitating European credit institutions' access to funding. The measures include most notably those stated below.

First, the Eurosystem has maintained the use of the fixed-rate full allotment procedure both for the main refinancing operations (MROs) and for maintenance period operations. Further, financing operations with a maturity of three months have continued to be conducted under the fixed-rate full allotment arrangement, where the rate is the average rate of MROs over the life of the respective three-month operation. In August, the Eurosystem conducted a supplementary six-month operation (this had not been done since May 2010), and in October it announced two supplementary operations with maturities of 12 and 13 months, to be conducted in October and December 2011, respectively (the last 12-month operation was in December 2009). These three supplementary operations follow the fixed-rate full allotment procedure, taking the average rate on MROs over the life of the operation as their rate.

The ECB Governing Council decided in August to reactivate its Securities Market Programme, in force since May 2010. Moreover, in October it announced the start of a second covered bond purchase programme for €40 billion, which will run from November 2011 to October 2012.

Foreign-currency liquidity provision measures have also been taken. In June it was decided to extend the swap line agreement with the Federal Reserve, due to end in August 2011, to August 2012. One-week US dollar liquidity-providing operations in dollars, conducted through fixed-rate full allotment, would also be continued. Also extended in August was the swap line agreement with the Bank of England, to September 2012 (it was scheduled to run to September 2011). Further, on top of the weekly operations, three additional three-month US dollar liquidity-providing operations were announced in September. These operations will take place in October, November and December 2011 using the fixed-rate full allotment procedure.

…, which in Spanish institutions also rose, but by much less than in July 2010

As a result, the gross lending to Spanish institutions, expressed as a percentage of the Eurosystem total, increased in this period. Chart 2.6.D shows the amount granted to institutions resident in Spain relative to the total provided by the Eurosystem. As can be seen, the percentage allotted in tenders to institutions resident in Spain increased with respect to the low amounts of the first quarter of 2011, although it remains well below the highest levels recorded in summer 2010. Compared with the average of 11% for February 2011, the figure in September was 15%, while the maximum of 23% was reached in July 2010.

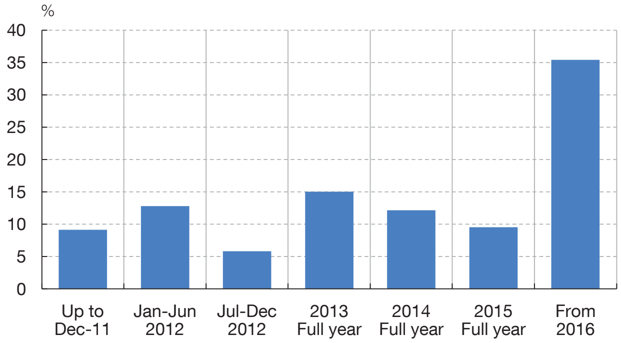
For reasons of current juncture (market difficulties) and of a more structural nature (relative importance of wholesale funding in bank balance sheets), deposit institutions are changing their liability-side structure. This leads to greater recourse to retail deposits, which for Spanish institutions are showing continuous positive year-on-year rates of change despite the difficult times which the Spanish economy is going through (see Chart 2.7.A). The ongoing expansion of deposits taken from non-financial corporations and households contrasts with the notable slowdown, and in recent quarters, fall, in credit to these sectors. As a result, the difference between the rates of deposits and credit growth has turned positive (deposits are increasing more quickly than loans) from mid-2008 to the present (see Chart 2.7.B). This performance of deposits and the decrease in credit, together with divestments of other assets, diminish the need for rolling over wholesale funds. The available information indicates that this roll-over requirement has decreased by around 50%.

These changes in the composition of the liabilities of deposit institutions have brought a notable increase in competition between institutions to attract time deposits. The resulting higher rates offered for new deposits have edged above EURIBOR and, although passed through only gradually to average rates (and thus to the net interest margin), are putting more pressure on income statements. This additional pressure, although a product of the heightened competition to attract retail saving, also reflects the wholesale funding conditions of financial markets that are not functioning normally.

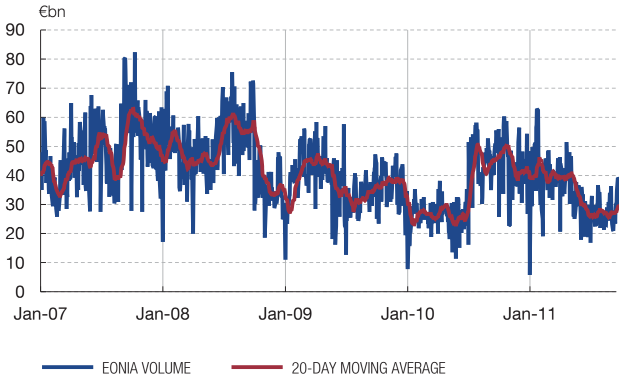
WHOLESALE FUNDING

CHART 2.6

A. MATURITY STRUCTURE OF WHOLESALE FUNDING OF SPANISH DEPOSIT INSTITUTIONS (INCLUDING SHORT-TERM SECURITIES)

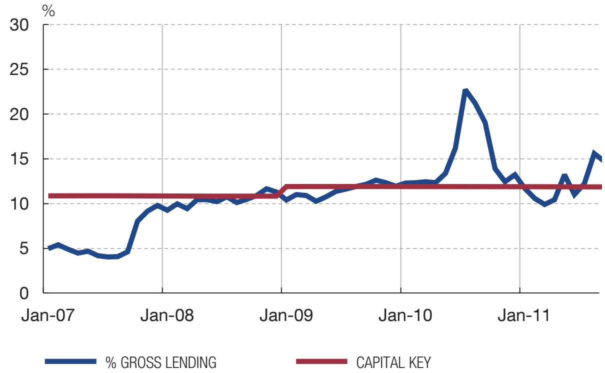


B. EONIA TRADING VOLUME.
Latest data: 14 October 2011



C. OUTSTANDING AMOUNT PROVIDED THROUGH EUROSYSTEM TENDERS.
Latest data: 14 October 2011

D. EUROSYSTEM GROSS LENDING TO SPAIN AS A PERCENTAGE OF TOTAL LENDING.
Latest data: September 2011

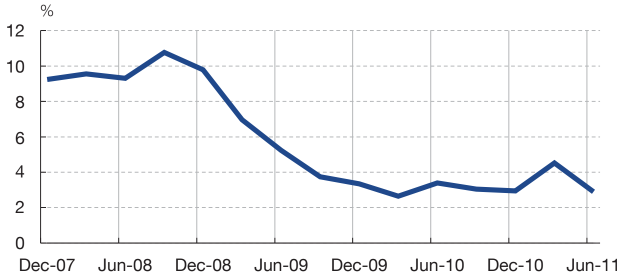


SOURCES: Bloomberg and Banco de España.

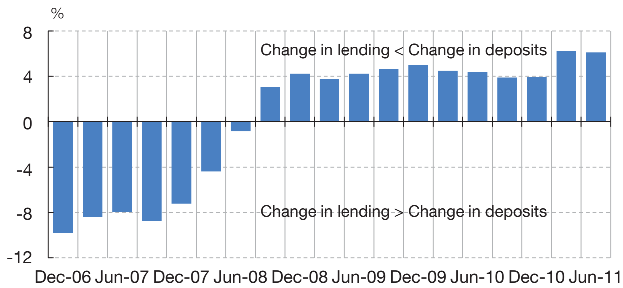
DEPOSITS OF NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS
Business in Spain, ID. Deposit institutions

CHART 2.7

A. YEAR-ON-YEAR RATE OF CHANGE IN DEPOSITS



B. DIFFERENCE BETWEEN THE RATES OF CHANGE OF DEPOSITS AND LENDING



SOURCE: Banco de España.

In this respect, the first final provision of Royal Decree 771/2011 establishes a system of contributions to deposit guarantee funds which, in line with the work of the European Commission, links the institutions' contributions to the risk they assume. Thus, the Royal Decree requires additional contributions to deposit guarantee funds compulsory by institutions which remunerate time deposits or settle sight accounts above certain rates of interest. This reform has also helped to moderate the excessively aggressive commercial policies pursued by some institutions.

2.1.2 PROFITABILITY

Negative pressures on profitability persist

From January to June 2011 Spanish deposit institutions recorded consolidated income attributable to the controlling entity of €7,835 million (see Table 2.2). In terms of average total assets (ATA), at 0.44% this was 13 bp lower than in June 2010. The return on equity (ROE) was 7.4%, which was also lower than in the same period of the previous year (9.5%). This fall particularly affected institutions with higher returns, but not those with a relatively lower ROE (left-hand part of the function depicted in Chart 2.8.A).

The profitability of the banking sector is under pressure. The fall in profit before tax between June 2010 (0.77% of ATA) and June 2011 (0.57%) is basically explained by two factors: first, the reduction in net interest income; and second, the continued high level of asset impairment losses, reflecting specific provisions (see Chart 2.8.B).

The growth of financial costs (33.1% between June 2011 and June 2010) was more pronounced than the increase in financial revenue (9.8% over the same period), which resulted in a fall in **net interest income** of 7.9% in absolute terms (see Table 2.2). The decline in net interest income is sharper if Spanish banks with high levels of international activity are excluded from the analysis (1.1% of ATA in June 2011 and 1.3% in June 2010).

Net interest income is falling

The gradual reduction in the net interest spread (difference between the average return on assets and the average cost of liabilities; see Chart 2.9.A) is putting downward pressure on net interest income, although the downward trend in the net interest spread on new business seems to have reversed in recent months. Should this development persist, it would be

CONSOLIDATED INCOME STATEMENT
DEPOSIT INSTITUTIONS. JANUARY-JUNE 2011

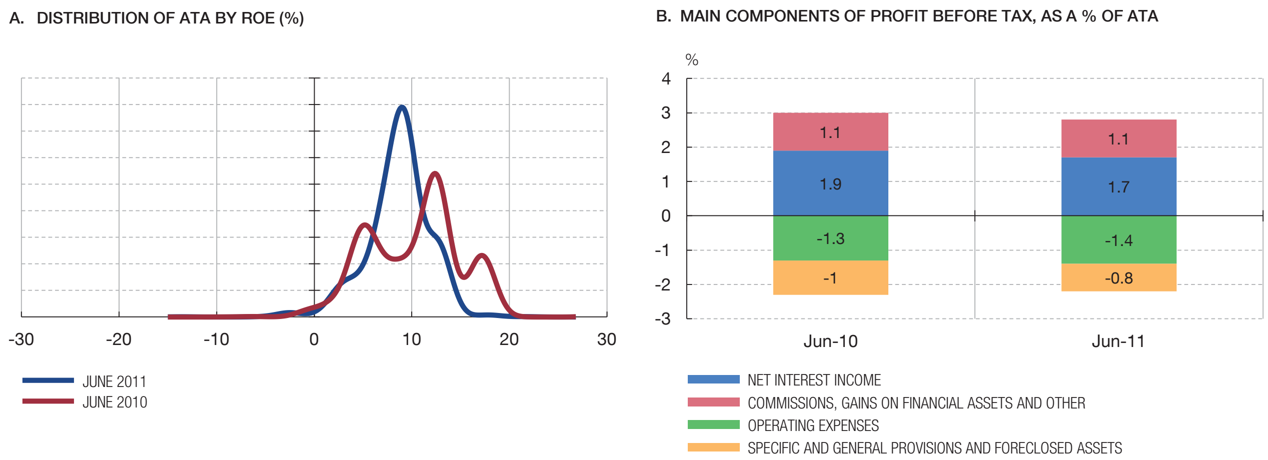
TABLE 2.2

	Jun-11		Jun-10	Jun-11
	€m	% Change Jun-11/Jun-10	% ATA	% ATA
Financial revenue	65,613	9.8	3.36	3.66
Financial costs	34,433	33.1	1.46	1.92
Net interest income	31,179	-7.9	1.91	1.74
Return from capital instruments	1,435	-5.1	0.09	0.08
Share of profit or loss of entities accounted for using the equity method	2,385	37.2	0.10	0.13
Net commissions	11,899	5.5	0.63	0.66
Gains and losses on financial assets and liabilities	4,068	-31.8	0.34	0.23
Other operating income	-426	n.s.	-0.01	-0.02
Gross income	50,541	-6.8	3.05	2.82
Operating expenses	24,982	4.9	1.34	1.39
Net operating income	25,559	-15.9	1.71	1.43
Asset impairment losses (specific and general provisions)	12,204	-19.7	0.86	0.68
Provisioning expense (net)	2,247	72.1	0.07	0.13
Operating profit	11,108	-20.1	0.78	0.62
Asset impairment losses (assets other than loans and credits)	2,548	40.5	0.10	0.14
Income from disposals (net)	1,699	11.1	0.09	0.09
Profit before tax	10,260	-24.6	0.77	0.57
Net income	8,891	-19.9	0.62	0.50
MEMORANDUM ITEM				
Income attributable to the controlling entity	7,835	-22.0	0.57	0.44

SOURCE: Banco de España.

PROFITABILITY
Deposit institutions

CHART 2.8



SOURCE: Banco de España.

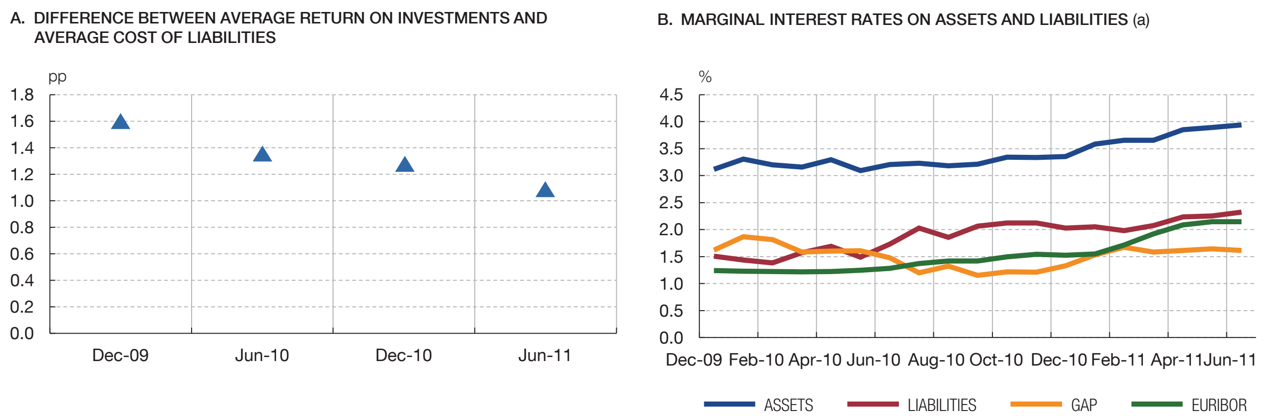
passed through to the average net interest spread (see Chart 2.9.B). However, the ability to pass higher borrowing costs through to lending rates is limited, although this helps to contain the increase in the doubtful assets ratio. In the next few months the negative pressures on net interest income, stemming from the developments in financial costs and from the continued high volume of non-interest earning doubtful assets, will persist.[6]

The growth of commissions (5.5% between June 2010 and June 2011; see Table 2.2), basically stemming from those for collection and payment services, and from the sale of non-banking financial products, did not fully offset the reduction in gains and losses on financial assets and liabilities (-31.8% in the reference period). Accordingly, the fall in net interest income was passed through to gross income.

6 Also, assets foreclosed in settlement of debts generate maintenance and management costs that have an adverse impact on the income statement, in addition to the fact that they do not generate any financial income.

REVENUE AND FINANCIAL COSTS
Deposit institutions. ID

CHART 2.9



SOURCE: Banco de España.

a Marginal interest rates are those established in transactions initiated or renewed during the month prior to that of reference, such transactions being weighted by their volume. The assets-weighted marginal rates include, inter alia, those applied to housing and consumer finance and credit to non-financial corporations, while the liabilities-weighted ones include, inter alia, fixed-term deposits and repos.

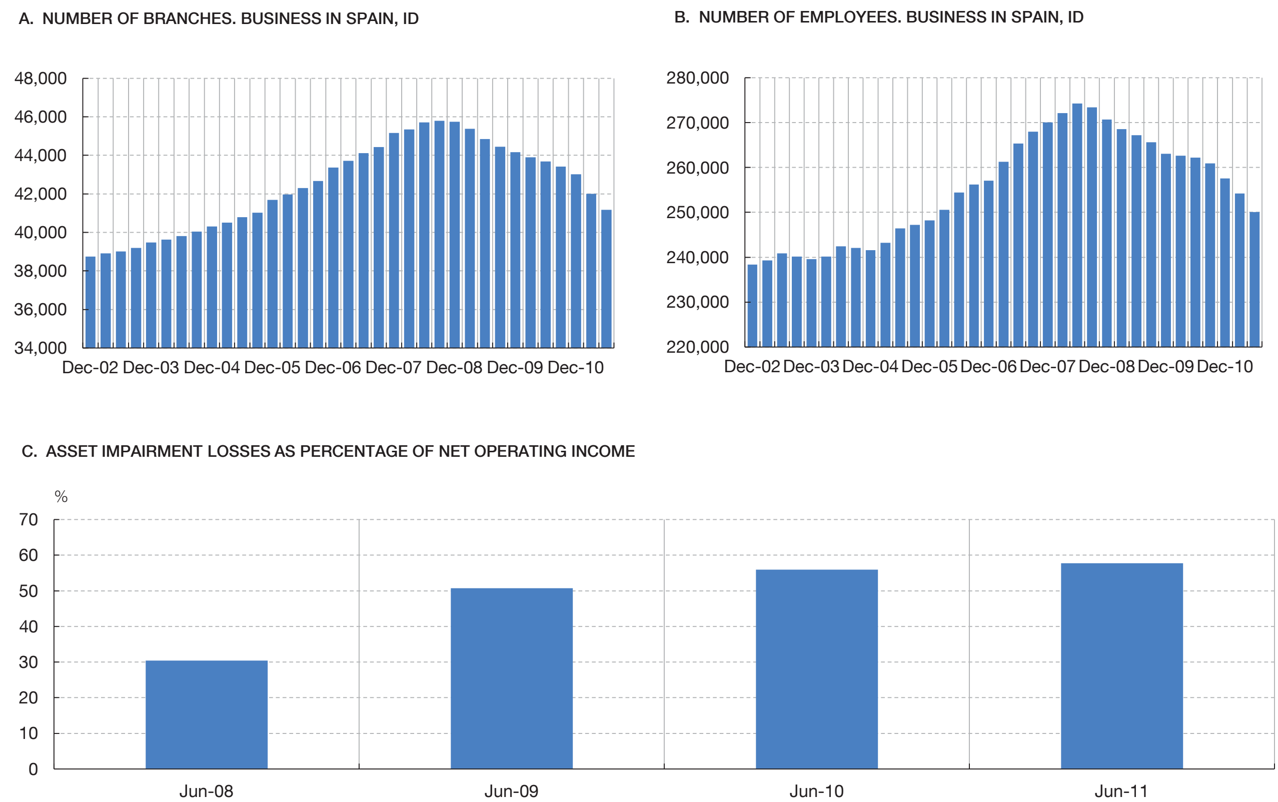
Operating expenses increased by 4.9% between June 2010 and June 2011. This rate of increase, which may appear to be high, is partly explained by changes in the scope of consolidation and by exchange rate developments, which affect institutions with a significant international presence. For their part, those savings banks involved in restructuring processes, recorded a 5.5% fall in operating expenses between June 2010 and June 2011. In line with this, in the case of business in Spain, the number of offices and of employees have been falling continuously since late 2009 (see panels A and B of Chart 2.10), both variables having returned to similar levels to those existing in late 2005.

Asset impairment losses remain high

In any case, given the pressures on the ability to generate net interest income, which will probably persist, and the continued high level of asset impairment losses, institutions will have to persevere in reducing their overhead costs. Indeed, impairment losses on financial assets (specific provisions) and those associated with other assets (largely reflecting provisions for foreclosed assets and dations in payment of debts) continue to absorb a significant portion of the net operating income of deposit institutions. Although these provisions declined relative to June 2011, largely because in December 2010 provisions charged to reserves were made in various integration projects, which may affect the comparison in the flow of asset impairment losses, the fall in net operating income more than offset this decline. As a result, asset impairment losses deducted 57.9% in June 2011, as against 56% in June 2010 (see Chart 2.10.C).

In the next few quarters the volume of asset impairment losses can be expected to remain high. This, along with the foreseeable adverse trend in net interest income, constitutes a difficult scenario for the income statement of Spanish banks.

OPERATING EXPENSES AND ASSET IMPAIRMENT LOSSES. Deposit institutions **CHART 2.10**

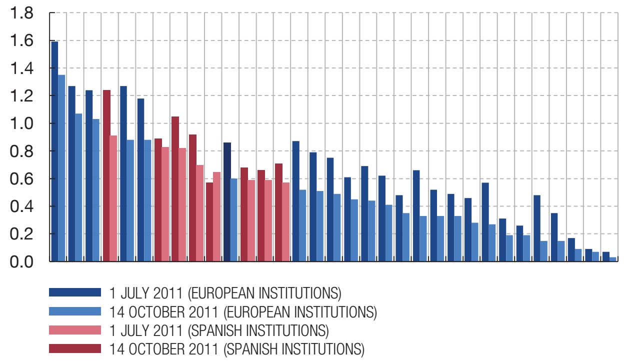


SOURCE: Banco de España

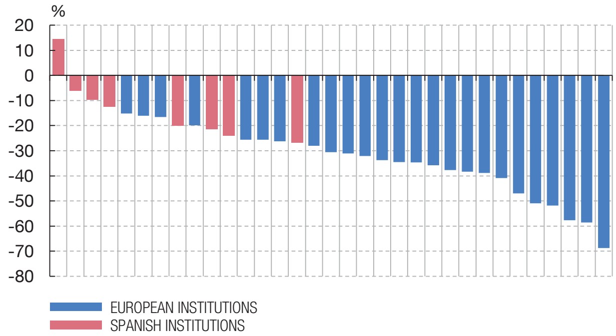
MARKET INFORMATION
International comparison

CHART 2.11

A. PRICE-TO-BOOK VALUE RATIO. BIGGEST EUROPEAN INSTITUTIONS (a)



B. STOCK MARKET FALL BETWEEN 1 JULY AND 14 OCTOBER 2011 (b)



SOURCE: Datastream.

a Each pair of bars represents an institution. Latest data: 14 October 2011.
b Each bar represents an institution. Latest data: 14 October 2011.

The viability of Spanish banks' business model helps to mitigate those elements that are having a negative effect on the income statement. Thus, the ratio between the market value and book value of Spanish banks compares favourably with that in other banking sectors (see Charts 2.11.A and B). That said, the trend in the market prices of financial institutions is downward, which is reflected in reductions in the ratio between the market value and book value of banks (see panels A and B of Chart 2.11). In a context characterised by the instability of European securities markets, especially in their financial segments, various European authorities, including the CNMV, banned transactions in securities or financial instruments that involved establishing or increasing net short positions in financial sector shares.

2.1.3 SOLVENCY

The solvency of Spanish deposit institutions has improved

The overall **solvency ratio** was 19 bp higher in June 2011 than a year earlier and stood at 12%.[7] The Tier 1 ratio was 94 bp higher, at 10% (see Chart 2.12.A). Meanwhile, the core capital ratio, defined as capital plus reserves, less goodwill, stood at 8.5% in June 2011 (8% in June 2010). The increase in the Tier 1 ratio was a widespread phenomenon among deposit institutions (see Chart 2.12.B).

The increase in the overall solvency ratio occurred in spite of the fall in total own funds (which occurred due to the sharp reduction in lower quality Tier 2 capital, and in spite of the increase in Tier 1 capital), and as a consequence of the decline in risk-weighted assets.

Risk-weighted assets have declined …

Risk-weighted assets, the denominator of the solvency ratio, decreased by 5.6% in June 2011 (see Chart 2.13.A). In line with the lower lending activity in the period, credit risk requirements, with a weight of 88% in the total, fell by 5.5%. Requirements for operational risk (with a weight of 9%) slowed by almost 9 pp to a rate of increase of 1.2%, while those arising from price and exchange-rate risk (2% weight) fell by 27.2%.

… and Tier 1 capital has increased

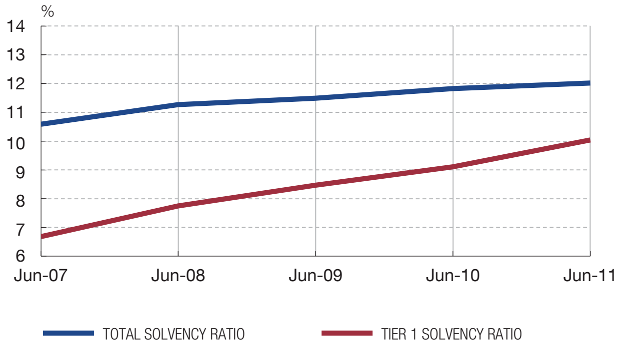
Total own funds fell by 4.1% in June 2011 relative to the same period of the previous year (see Chart 2.13.B). This reduction is explained by the sharp contraction in Tier 2

7 From June 2008 the figures are calculated in accordance with CBE 3/2008, which transposes into Spanish law the EU directives setting out the changes to solvency rules made by Basel II.

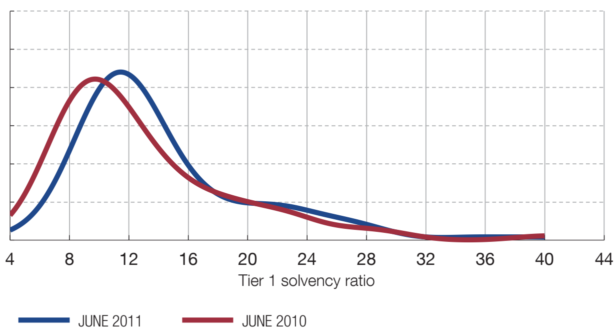
SOLVENCY
Deposit institutions

CHART 2.12

A. TOTAL AND TIER 1 SOLVENCY RATIOS



B. DISTRIBUTION OF NUMBER OF INSTITUTIONS ACCORDING TO TIER 1 RATIO (%) (a)



SOURCE: Banco de España.

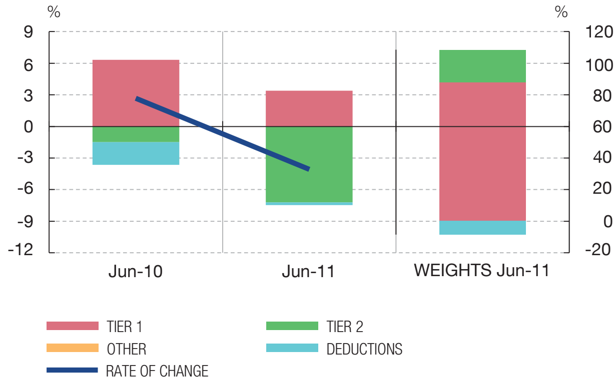
a Non-parametric estimation of the density function, which provides a continuous and smoothed graphic representation of such function. As it is based on the number of institutions, they all have the same weight in the distribution without the larger ones being more weighted. A shift rightwards in the distribution denotes an improvement in solvency.

CAPITAL REQUIREMENTS AND OWN FUNDS
Deposit institutions

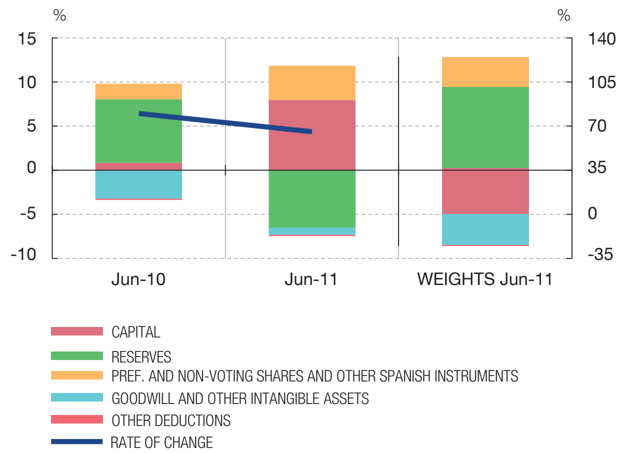
CHART 2.13

A. REQUIREMENTS. CONTRIBUTION TO RATE OF CHANGE AND COMPOSITION (right-hand scale)

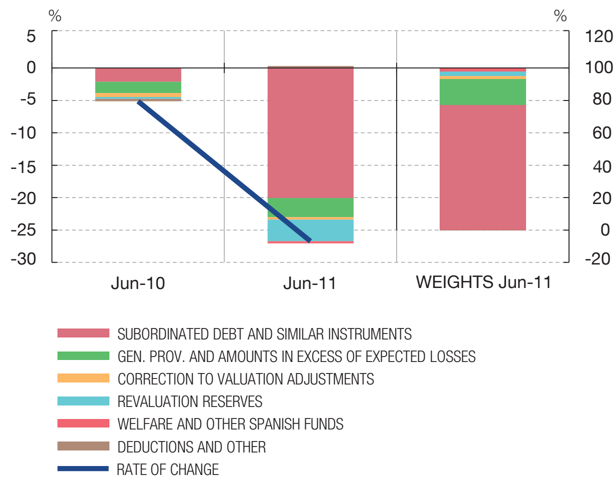
B. OWN FUNDS. CONTRIBUTION TO RATE OF CHANGE AND COMPOSITION (right-hand scale)



C. TIER 1 CAPITAL. CONTRIBUTION TO RATE OF CHANGE AND COMPOSITION (right-hand scale)



D. TIER 2 CAPITAL. CONTRIBUTION TO RATE OF CHANGE AND COMPOSITION (right-hand scale)



SOURCE: Banco de España.

capital (26.7%) and conceals an improvement in the overall quality of own funds, since Tier 1 capital continued to grow (4.2%).

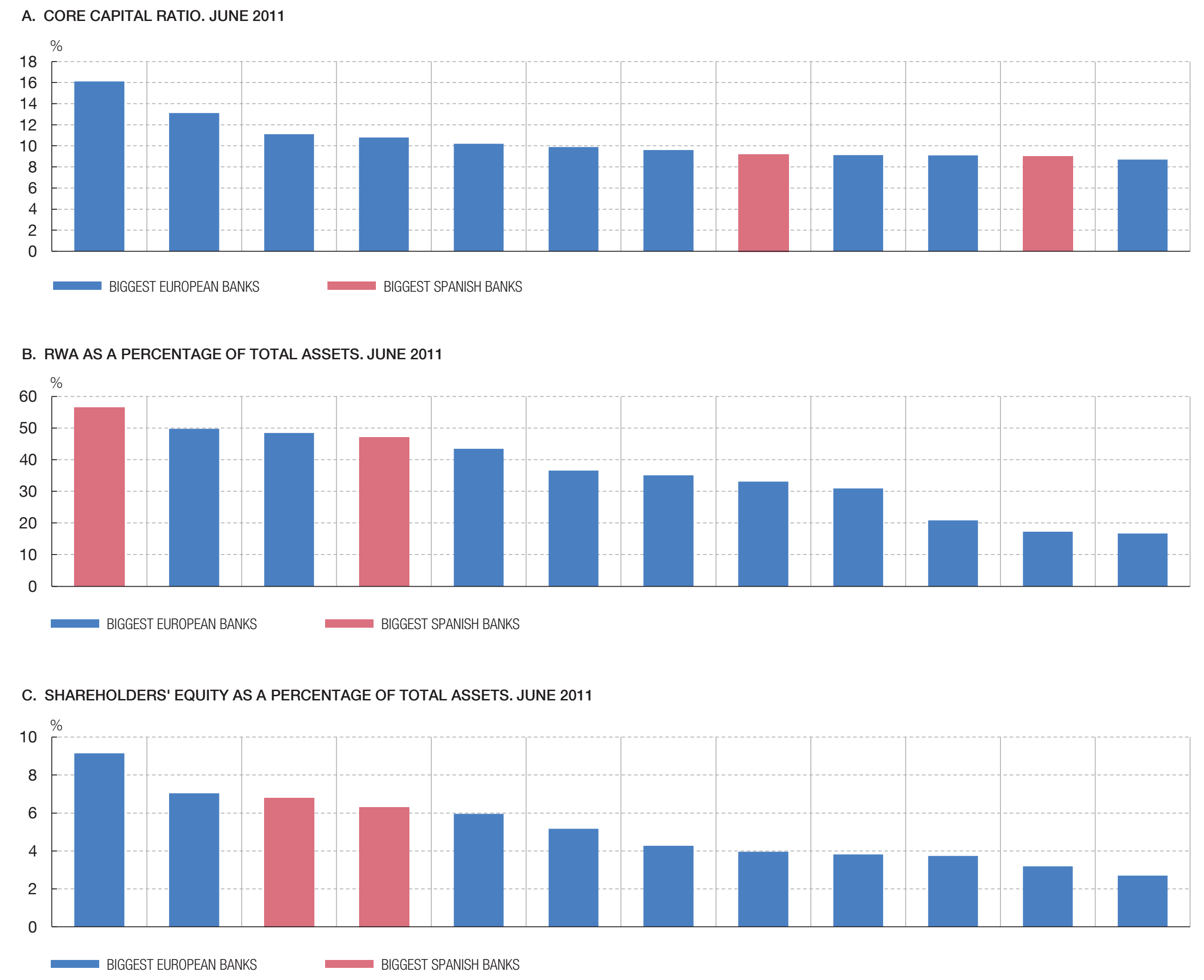
Tier 1 capital – the highest quality own funds – continued to grow in June 2011 thanks to the sharp increase in capital, which accelerated by 23.6 pp from a rate of 2.6%, offsetting the reduction in reserves and intangible assets, the growth of the latter being less forceful than in June 2010 (see Chart 2.13.C). The increase in capital, and the reduction in reserves, is largely explained by the restructuring processes, which have involved the restructuring of balance sheets (and a decline in reserves), while the transfer of the activity of savings banks to commercial banks also increased capital and (further) reduced reserves.

Tier 2 capital fell more sharply than in the previous year (26.7%), as a result of a fall in all its components (see Chart 2.13.D).

European institutions show a high level of dispersion in their leverage ratios

The capital ratio of large Spanish institutions stands in a medium-low position in relation to other comparable European institutions (see Chart 2.14.A). However, the other European institutions record lower risk-weighted assets, discernible on account of the lower weight

SOLVENCY OF THE BIGGEST EUROPEAN BANKS (a) **CHART 2.14**



SOURCE: Financial reports of the banks in question.

a The two biggest banks in Spain, France, Italy, Germany and Switzerland are taken. Each panel depicts the banks in descending order for the variable in question.

of the latter in total assets (see Chart 2.14.B). In this situation, a recent initiative of the Basel Committee to analyse the consistency of assets in terms of risk at the international level, is especially significant. European institutions also show a high level of dispersion in their leverage ratios (inverse relationship between accounting own funds and total assets; see Chart 2.14.C).

2.2 OTHER FINANCIAL MARKET PARTICIPANTS

The insurance sector is facing risks arising from the macro and financial envirionment.

The insurance sector is also going through a period of heightened risk, while from a medium-term perspective, the application of Solvency II is an important challenge for the companies. More immediate elements of pressure include the adverse economic situation, which affects those sectors whose earnings are more cyclically dependent, and others in which the volume of activity may be affected.

The situation on stock markets, which have been moving downwards, adversely affects the equity holdings of insurance companies. In the Spanish case, the relatively low weight of equities on the balance sheets of insurance companies means that this is a relatively unimportant risk factor.

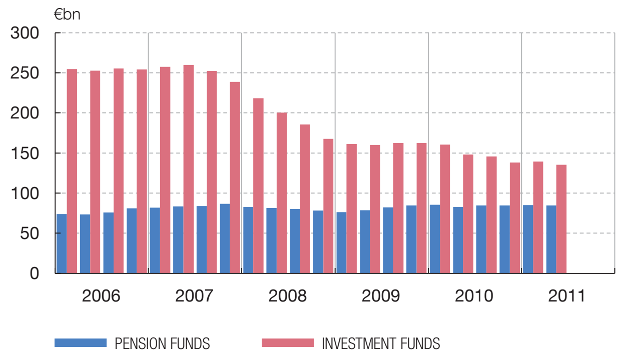
Finally, periods of low interest rates have a negative impact on the insurance sector, a risk which is all the greater the less well matched the maturities of its assets and liabillities. This situation of pressure arising from the interest rate environment is compounded by the general uncertainty stemming from the euro area sovereign debt crisis, which poses additional risks for the insurance sector.

Investment funds continue to record reductions in their net assets

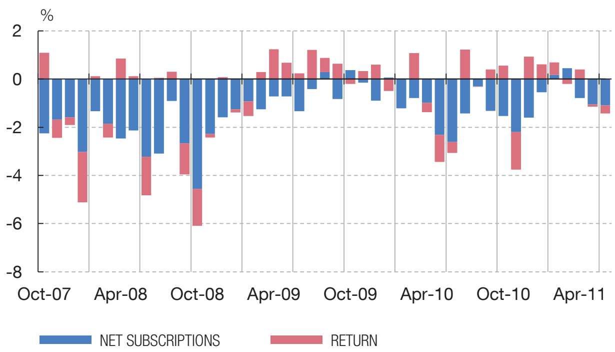
The climate of stress, lack of confidence and uncertainty predominating on the financial markets is not at all favourable for pension funds and investment funds and the downward trend in the net assets of investment funds persists (see Chart 2.15.A). This is, first, a consequence of the negative impact of the returns achieved in such a difficult environment as the present one, and, second, of the subscriptions net of withdrawals, since the former are not sufficient to offset the latter (see Chart 2.15.B). Factors responsible for this situation are the financial market situation, and probably the greater competition with the banking sector to attract savings.

INVESTMENT AND PENSION FUNDS **CHART 2.15**

A. ASSETS OF INVESTMENT FUND AND PENSIONS FUNDS



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



SOURCES: INVERCO and Banco de España.

3 THE EUROPEAN SYSTEMIC RISK BOARD AND MACRO-PRUDENTIAL OVERSIGHT IN EUROPE

The financial crisis has underlined the need for regulation and macro-prudential supervision

The crisis, which began more than four years ago, has underlined the need to improve various aspects of financial regulation and supervision, which were unable to prevent an excessive build-up of risks in the financial system. One of the main lessons learned is the need to complement the improvements in traditional prudential oversight with the new emphasis on the so-called "macro-prudential approach". In contrast with the micro-prudential approach, which focuses on ensuring the solvency of the components of the financial system on an individual basis, the objective of the macro-prudential approach is to guarantee the soundness of the financial system as a whole, paying particular attention to interactions between agents in the financial system, and between the latter and the real economy.

The main developed economies have created new macro-prudential supervisory authorities …

In this context, multilateral organisations such as the G-20 and the Financial Stability Board have insisted on the need to develop new macro-prudential frameworks to correct the shortfalls detected. In response to this demand, the main developed economies have created new authorities in charge of macro-prudential supervision, such as the Financial Stability Oversight Council in the United States or the European Systemic Risk Board (ESRB) in the EU.

… such as the European Systemic Risk Board (ESRB) in the EU

The ESRB was conceived as an essential component of the new architecture of the European System of Financial Supervision (ESFS). The three new European Supervisory Authorities, the Joint Committee of the European Authorities and the national supervisory authorities of Member States are also part of this new architecture. Following a complex legislative process and several months of preparatory work, the legislation regulating the functioning of the ESRB came into force on 16 December 2010 and the institution began to function officially on 1 January 2011.

The General Board is its main decision-making body

The main decision-making body of the ESRB is its General Board. It consists of the following members with voting rights: the President of the ECB (who will chair the ESRB for the first five years), the Vice-President of the ECB, the Governors of the central banks of Member States, one representative of the European Commission and the chairpersons of the three European Supervisory Authorities, in addition to four representatives of the advisory committees of the ESRB. Additionally, the representatives of the national supervisory authorities and the President of the Economic and Financial Committee (representing the Council) are members without voting rights. Therefore, the design of the ESRB confers a fundamental role on central bank representatives, who have an ample majority.

The size of this body, in which more than 60 institutions are represented, presents a challenge in terms of its effective management. However, this design has the advantage of including all the institutions which can contribute relevant information and experience and, consequently, it will have a very broad perspective of the financial system's problems as a whole. The General Board will hold four meetings a year, although extraordinary meetings may be convened when so required.

The ESRB's objective is to prevent or mitigate systemic risks which may threaten the EU's financial stability

The ESRB is responsible for the macro-prudential oversight of the EU's financial system, in order to prevent or mitigate systemic risks which may threaten the EU's financial stability as a result of developments in the financial system and paying particular attention to the general performance of the economy. The ultimate goal of the ESRB is to avoid fresh bouts of widespread financial crisis in the future and to ensure that the financial system makes a sustainable contribution to economic growth.

Therefore, the ESRB has a broad mandate covering all the institutions, products and infrastructures in the financial system and pays attention to interrelationships within the financial system (the cross-sectional dimension of systemic risk) and potential risks stemming from the relationship between financial activity and the economic cycle (time dimension of systemic risk). The two essential elements of the ESRB's mission are prevention, which requires anticipation to minimise the probability of bouts of financial instability, and mitigation, which focuses on limiting the consequences for the financial system and the economy as a whole should a risk materialise (that is, making the system more robust and increasing its shock-absorbing capacity).

In order to fulfil this objective, the ESRB can issue warnings and recommendations …

The regulation defines two policy instruments for the ESRB: warnings and recommendations. The warnings draw attention to potential risks to financial stability without specifying which actions should be taken to prevent or mitigate them. By contrast, the recommendations prescribe specific measures for addressing a particular risk and establish a timeframe for them to be applied.

The ESRB's recommendations are non-binding, since those to whom they are addressed have no legal obligation to apply the measures proposed. Their effectiveness is based on the formal obligation of the addressees to "act or explain". Thus, the addressees of the recommendations will inform the ESRB about compliance with said recommendations. On the basis of these reports, the ESRB will assess the degree of compliance with the recommendations and in case of inaction (or inadequate reaction), it may inform the Council and, where appropriate, the European Supervisory Authorities.

… based on sound analytical evidence …

The warnings and recommendations must be based on sound analytical evidence and under no circumstances will they address private components of the financial system (individual institutions, infrastructures, etc.), but rather they will be sent to national and European authorities. The recommendations may refer to a broad set of "macro-prudential policy" instruments. In this respect, work is still ongoing as regards the definition of a set of suitable instruments to achieve macro-prudential policy objectives. In general, the vast majority of instruments which are considered for use are traditional prudential tools that have been readjusted for macro-prudential purposes. Some notable examples in this connection are counter-cyclical capital buffers, dynamic provisions and capital charges for systemically important institutions.

…which may be public or confidential

Warnings and recommendations may be public or confidential. Their publication may make it easier for measures to be adopted by the addresses and it could contribute to improving the general public's understanding of the ESRB's activity. However, when deciding about the possible publication of warnings and recommendations the potential adverse effects of disseminating them should be assessed. On occasions, the matters discussed will be extremely sensitive and should the ESRB point out specific risks, it could lead to exacerbating rather than mitigating the risks to the system as a whole. For this reason, the publication of warnings and recommendations is studied on a case-by-case basis and requires an ample majority (of two-thirds) of the ESRB's General Board.

In short, the ESRB's core activities comprise compiling information about the financial system, identifying and prioritising potential systemic risks, issuing public or private warnings and recommendations, where it is considered that these risks are important, and monitoring compliance with recommendations. Furthermore, the ESRB may informally convey its opinions on important issues for financial stability to national and European authorities. Also, in accordance with law, when the ESRB considers that an emergency could occur, it will issue a confidential warning to the Council. Finally, the ESRB must play an important role in achieving suitable coordination within the framework of the European System of Financial Supervision as well as with international or multilateral bodies with macro-prudential responsibilities such as the IMF, the Financial Stability Board or macro-prudential authorities which have been created recently in other countries.

In the early months of its existence, the ESRB has had to combine creating basic operating structures with analysing possible systemic risks in a period as convulsive as the present one

Pursuant to law, the ESRB is attributed a central role in the prevention and mitigation of systemic risk. By contrast, it has no direct powers in the area of crisis management and resolution (although the Council may request its assistance, if considered necessary). Therefore, its design is more appropriate for tackling the possible problems that emerge for financial stability in the medium and long term than for helping to manage these risks once they have materialised. However, the ESRB has begun to function in a convulsive period of considerable threats to financial stability in the EU. Consequently, in the early months of the ESRB's existence, it has had to combine creating its basic operating structures and studying possible sources of systemic risk in the medium term with analysing more immediate and pressing problems which are currently affecting the EU's financial system.

In the short term, its greatest concerns lie in the risks arising from the interplay of sovereign risk, funding problems in the banking system and the poorer outlook for economic growth

From a short-term perspective, the ESRB has followed up exhaustively the situation of Europe's financial system with the purpose of identifying and prioritising the main risks currently threatening the EU's financial stability. The ESRB's analysis underlines the deterioration of the situation in recent months. The main causes of concern are the risks stemming from the interplay between sovereign risk, financing problems in the banking system and the poorer outlook for economic growth. Furthermore, uncertainties about sovereign debt markets in the euro area have been transmitted from relatively small economies to larger countries, with the result that the current problems threaten the financial stability of the EU as a whole, that is, they are systemic. This uncertainty is reflected in various signs of market stress such as higher sovereign debt spreads, increased market volatility or lower availability of dollar-funding to European banks (which has led central banks to set up dollar-denominated liquidity assistance).

In the medium term, the ESRB is working on the development of a conceptual framework which favours the fulfilment of its objectives...

In tandem with this analysis of the current situation, the ESRB has been working on the creation of a conceptual framework to analyse and appropriately prioritise risks, together with a clear definition of the instruments available for developing an effective macro-prudential policy. In parallel with these general tasks, the ESRB has been studying a variety of specific aspects which could conceivably threaten the stability of the EU's financial system in the medium and long term. These include, most notably, the proliferation of lending in foreign currencies in certain EU countries, especially in Central and Eastern Europe. Recent fluctuations in certain exchange rates illustrate the risks incurred by households and corporations which enter into loans denominated in a currency other than the legal tender in their country. The ESRB has analysed this subject and worked on identifying a set of measures aimed at mitigating the credit, liquidity and financing risks, among others, which could stem from this activity. As a result, on 10 October the ESRB agreed for the first time to publish a set of measures to prevent and mitigate the risks associated with lending in foreign currencies.

… at the same time as it analyses various developments in the...

The ESRB is analysing many aspects of the financial system, including most notably: the implications for financial stability of the retail marketing of complex financial products; the effect of a low-interest rate environment on certain agents' incentives to assume risk; the growing

...financial system and their implications for financial stability

"financialisation" of commodity markets; the interconnectedness of financial markets; the behaviour and emergence of new "systemic components"; and the development of products (such as Exchange Traded Funds) or market practices (such as high frequency trading) which could ultimately pose new threats to financial stability. It can be expected that in the next few months the work in all these areas will make it possible to identify new potential sources of systemic risk and that, in certain cases, the ESRB may issue new (public or private) warnings or recommendations aimed at preventing them.

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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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