

ANNEX 2 ACTIVITY, RESULTS AND SOLVENCY OF CREDIT INSTITUTIONS



## Activity, results and solvency of credit institutions

In 2007, the activity, results and solvency of credit institutions (CIs) and their consolidated groups were affected by the high rate of growth of activity in Spain and its gradual deceleration from the middle of the year, along with a poorer growth outlook for the world economy. Also exerting a significant influence was the turbulence on international financial markets that arose when financial agents became aware of the negative impact of the increase in the default rate for sub-prime mortgage loans granted in the United States. This has not only affected the solvency and profitability of US financial institutions, particularly investment banks, but has also been transmitted internationally through complex structured products (resecuritisations), that are frequently hard to value. In addition, the impact of these mortgage losses has been exacerbated by the difficulty of identifying the final investors who bore the risk, generating a climate of mistrust that has ultimately affected other activities and markets that bear little relation to US mortgages. Against this background of distrust and sharp widening of the yield differentials demanded (which has also had an adverse effect on company share prices), there was a drastic reduction in liquidity in the money and capital markets.

Although Spanish CIs are not exposed to the risks of US sub-prime mortgages, they have not been able to avoid the indirect effects mentioned above. They thus placed great importance on liquidity management, seeking alternative financing in their traditional retail banking activity, while moderating the growth of their lending. In addition, they increased their room for manoeuvre through a fresh rise in securitisation, not with a view to placing the resulting securities on the market immediately, but to ensuring that they have a large amount of collateral that can be used to obtain liquidity. Profits surged, with higher returns on both assets and equity. The activities of CGs and their international presence contributed to risk diversification and to the stability of the activity and results of the Spanish banking system.

The solvency of the institutions remained well above the regulatory minimum levels, although the solvency ratio declined slightly. Also, the weight of tier 1 capital in total eligible capital increased, raising the quality of the latter from the prudential viewpoint. Minimum capital requirements for CI subsidiaries included in consolidated groups were, as is becoming usual, comfortably met (225% of the level of coverage). Finally, the information sent by mixed groups and financial conglomerates supervised by the Banco de España (BE) implies that insurance activities once again strengthened the solvency of the CGs included in them, since the latter's surplus of €46.7 bn rises to €50 bn in the case of mixed groups and financial conglomerates.

### **1 Activity of credit institutions and their consolidated groups<sup>1</sup>**

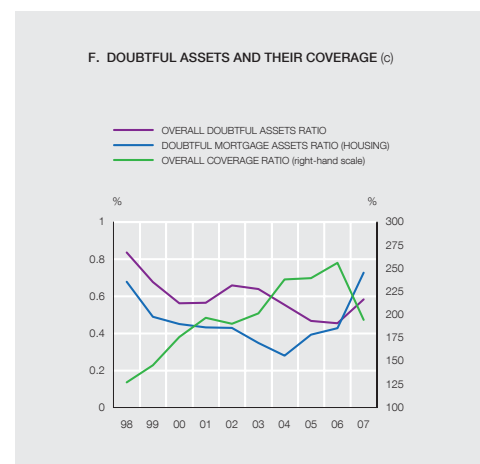
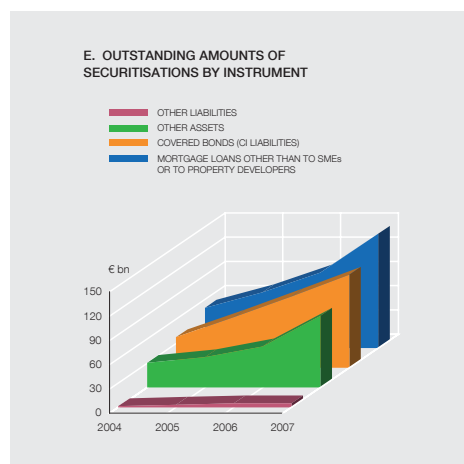
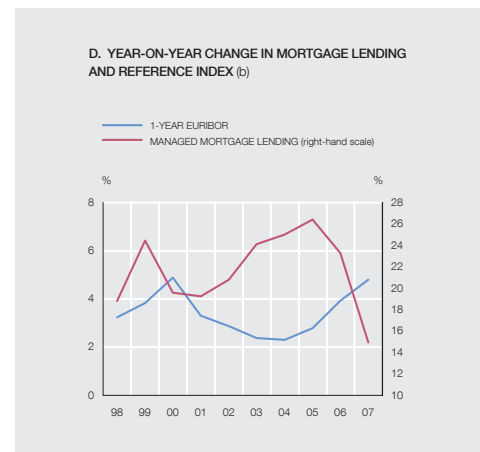
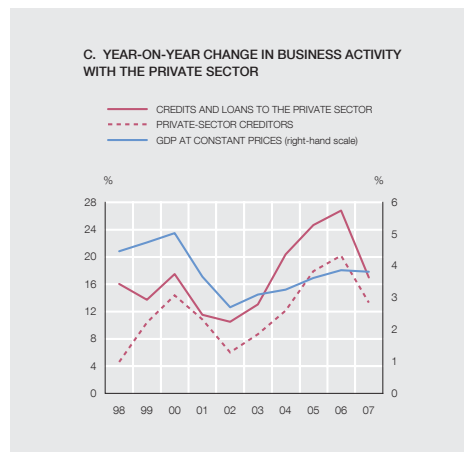
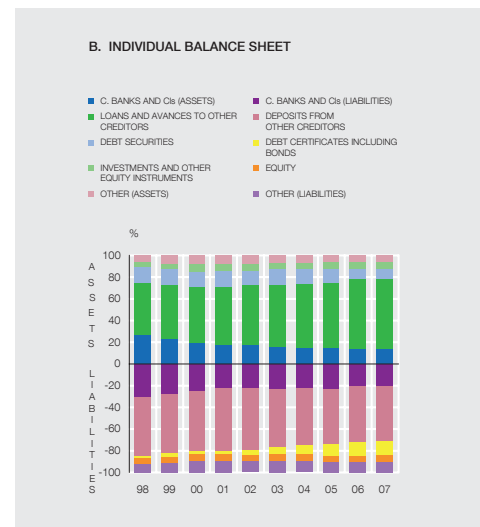
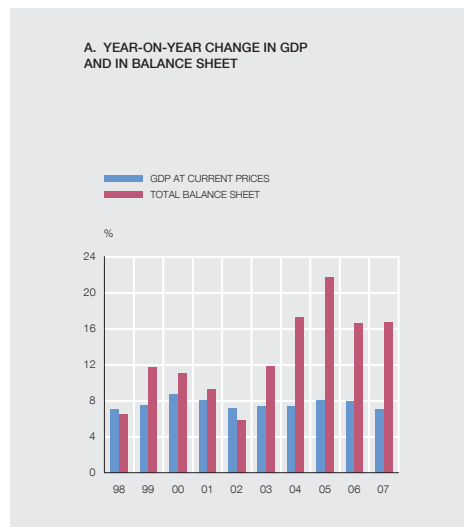
In 2007, Spanish CIs maintained the high rate of activity of the previous year, their balance sheet growing by 16.7% (see Chart A.2.1 A). This dynamism was largely attributable to financing to the resident private sector (the largest assets item, in absolute terms) which, despite slowing with respect to previous years, grew at the same rate as total assets. Mortgage lending rose by 15.3% with respect to the previous year, so that its relative importance in the balance sheet remained practically unchanged, although the component of financing for house

<sup>1</sup>. Although the data in the Banco de España's Report on Banking Supervision (RBS) are consistent with those contained in the Financial Stability Report (FSR), which is also produced by the Banco de España, they do not necessarily coincide precisely. There are various reasons for this, including the different scope of analysis (credit institutions in the RBS and deposit institutions in the FSR).

ACTIVITY OF CREDIT INSTITUTIONS (a)

CHART A.2.1

Total business. Year-end data



SOURCES: INE and Banco de España. Data available at end-February 2008.

- a. The data in this chart refer to the institutions active at each year-end.
- b. Managed mortgage lending includes mortgage lending to the resident private sector held on the balance sheet and that removed from the balance sheet due to transfer to third parties but the management of which is retained, as may be the case in asset securitisation.
- c. The overall doubtful assets ratio is defined as doubtful assets as a percentage of total lending in the total business of CIs. The doubtful resident mortgage assets ratio is defined, for business in Spain, as doubtful assets as a percentage of credit to the resident private sector for house purchases. The overall coverage ratio is defined as the sum of allowances, provisions and valuation adjustments as a percentage of total doubtful assets.

purchases grew at a lower rate. Trading derivatives and investments increased at rates well above those of the balance sheet, so that their weight in the balance sheet rose to 4% (up 0.7 pp from the previous year).

The structure of credit to the resident private sector changed slightly, with a continuation of the trend that began in 2005. Thus, the share of credit for productive activities continued to increase at the expense of credit to households, which fell to 45% of total credit (down almost 2pp from 2006).

Doubtful assets grew by 51.3% in 2007 (as against 16.3% in 2006), largely as a consequence of the rise in interest rates, given the preponderance of financing to other debtors at variable rates (three quarters of such financing), but also as a logical result of the sharp increase in credit in recent years, given the time lag between the granting of financing and the manifestation of default. This increase caused the doubtful assets and past-due ratios to rise in 2007, although in historical and international terms they remained low. Thus, doubtful assets rose to 0.58% of total lending (from 0.45% in December 2006). As for mortgage credit for house purchase, its past-due ratio rose by 30 bp, to 0.73%, one reason for this being that it is the component that has been most affected by the slowdown in lending. Although provisions increased by 14%, they grew by less than doubtful assets, but their amount is still more than twice that of the latter (see Chart A.2.1 F).

On the financing side, deposits from other creditors grew by 13.4% in 2007, time deposits standing out with growth of 26%. CIs offered very competitive returns on this type of deposit, which led to a slight fall in relative terms in overnight deposits. To finance the growth of activity, deposits from other creditors were supplemented by the issuance of debt certificates including bonds (commercial paper, mortgage securities), the outstanding amount of which grew by 25.3%, and by financing from credit institutions and from the European Central Bank, allotted in its ordinary liquidity tenders, which grew by 18%. Despite this growth, as at end-2007 the net loan obtained from the ECB by Spanish CIs accounted for only a small portion of their liabilities (1.3%) and represented barely 10% of the total financing granted by the ECB in the Eurosystem, in line with the weight of the Spanish economy in the euro area.

As regards the various institutional groups, commercial banks recorded the largest increase in cash and deposits with central banks (+16 pp), while savings banks lost share in respect of this item (-12 pp). At the same time, commercial banks and savings banks increased their weight in terms of holdings of debt securities and trading derivatives at the expense of the share of branches of foreign CIs which, in contrast, increased their share in loans and advances to other debtors by 0.6 pp at the expense of commercial banks and SCIs. In this respect, the acquisitions of SCIs by foreign branches must be taken into account. On the liabilities side it is worth noting that savings banks were the most active issuers of marketable securities, which enabled them to raise their share by more than 2 pp, basically at the expense of commercial banks.

With respect to securitisation, the market situation did not dissuade institutions from continuing this activity, the volume of issuance growing by 46.3%. While waiting for markets to return to normal, traditional asset securitisation enhances the liquidity management capacity of Spanish CIs by converting illiquid assets into securities that are eligible collateral in refinancing operations. In short, liquidity risk has triggered some of the most recent episodes of banking difficulties in other countries and it has been given special attention by Spanish CIs, this attention being favourably viewed by the Banco de España.

Against this background, CIs concentrated on the securitisation of high credit quality assets such as mortgage loans for house purchases, which grew by 62% (31% in 2006). The securitisation of loans to firms and other assets, such as leasing agreements or securities, also grew significantly and, for the first time in 2007, interbank loans were securitised, with a value of €13bn. In contrast to its buoyancy in 2006, the securitisation of consumer loans and loans to SMEs fell in 2007. Meanwhile, the securitisation of liabilities was focused exclusively on covered bonds and grew more slowly than in previous years. As for the distribution of securitised liabilities by originating institutions and issuers, while savings banks securitised 22% more than in 2006, commercial banks more than doubled their activity, which accounted for more than 50% of all issuance.

The activity of CGs grew at the same rate as in 2006 (14.8%) and the total balance sheet exceeded €3.3 trillion. The consolidated data confirmed the basic aspects already mentioned at the individual level. On the assets side, cash and deposits with central banks increased by 80% (6% in 2006); the growth of loans and advances to other debtors moderated to 15% (24% in 2006); and investments in associates almost doubled, to around 2% of the balance sheet. On the liabilities side, deposits from central banks and from credit institutions increased by 16% (as compared with a slight decline in 2006), deposits from other creditors maintained the same growth rate as in the previous year (13%), and minority interests, a relatively marginal item, rose by 90%.

The relative contributions to the total consolidated balance sheet of business in Spain and business abroad remained fairly stable overall, standing at 78.9% and 21.1%, respectively, as at end 2007. However, there were significant changes in certain assets items, notably: (i) cash and deposits with central banks increased to a greater extent in business in Spain, but even so represented only 68.6% of the total consolidated balance sheet (58.9% in 2006), less than the weight of business in Spain (78.9%); (ii) the holding of investments in associates by GCs gained importance in business abroad, rising to 46.4% (12.6% in 2006). On the liabilities side, the weight of deposits from central banks and credit institutions increased in business in Spain, as did that of certain minor items, such as subordinated liabilities and minority interests. As regards the geographical distribution abroad of the assets of consolidated groups, the EU accounted for over 50% and Latin America for around one third.

## **2 Results of credit institutions and of their consolidated groups**

The income statements of CIs reflected a very favourable performance despite the tightening of financing conditions stemming from the international financial turbulence recorded from summer 2007. The profits of CIs as a whole totalled €25.8 bn, up 30.7% from 2006, and represented 0.97% of average total assets (ATA) (0.87% in 2006) and 18.3% of equity (16.1% in 2006). The improvement in the efficiency ratio to 44.4%, from 48.7% in 2006, contributed to this positive outcome (see Charts A.2.2 A, A.2.3 C and D).

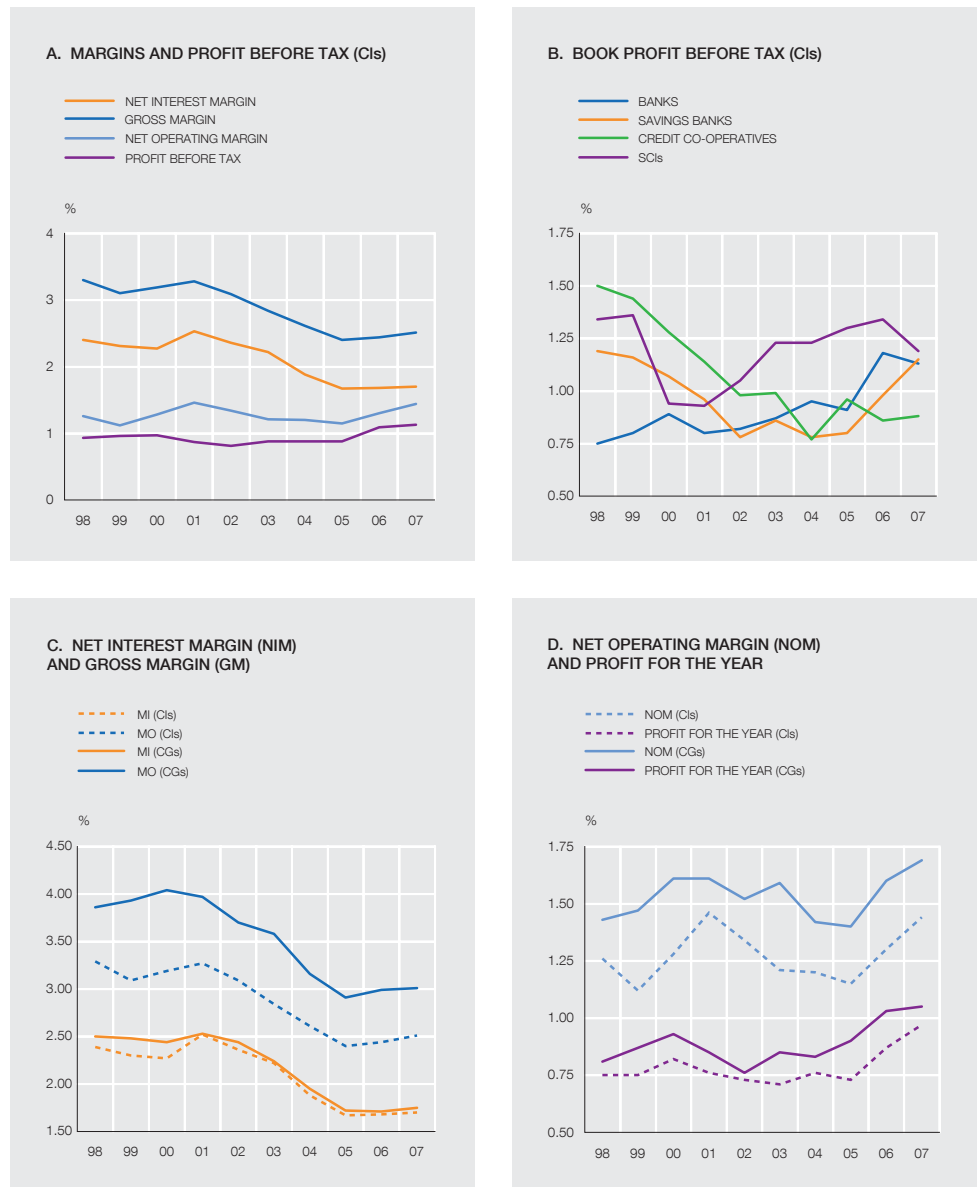
The favourable behaviour of profits was reflected in the various margins of the income statement, to a greater or lesser extent. The margins that improved most were gross income (GI), given the better behaviour of non-interest income relative to net interest income (NII); net operating income (NOI), owing to the moderation in operating expenses; and profit before taxes and, even more so, after taxes, given the fall in taxes on profits as a consequence of the tax changes during the year.

NII increased by 18.4% (18.8% in 2006) and, as a percentage of ATA, by 2 bp to 1.68%. This slight improvement in net interest income against a background of tightening financing conditions was made possible by the positive impact of the rise in interest rates on the profitability of assets financed with own funds. As a result, the contribution of the latter to NII rose from

**PROFIT AND MARGINS OF CREDIT INSTITUTIONS AND OF THEIR CONSOLIDATED GROUPS (a)**

CHART A.2.2

Percentage of ATA. Yearly data



SOURCE: Banco de España. Data available at 29 February 2008.

a. The data in this chart refer to the institutions active at some time during each year. The label "Cis" denotes individual data; "CGs" denotes consolidated data, among which are included those relating to individual Cis not belonging to any CG.

18% to 21.5% of NII. Financial income increased by 42.1%, while financial costs increased by 59.2%, as a result of a decline in the total spread<sup>2</sup> by 6 bp to 1.52% in 2007 (see Charts A.2.3 A and B).

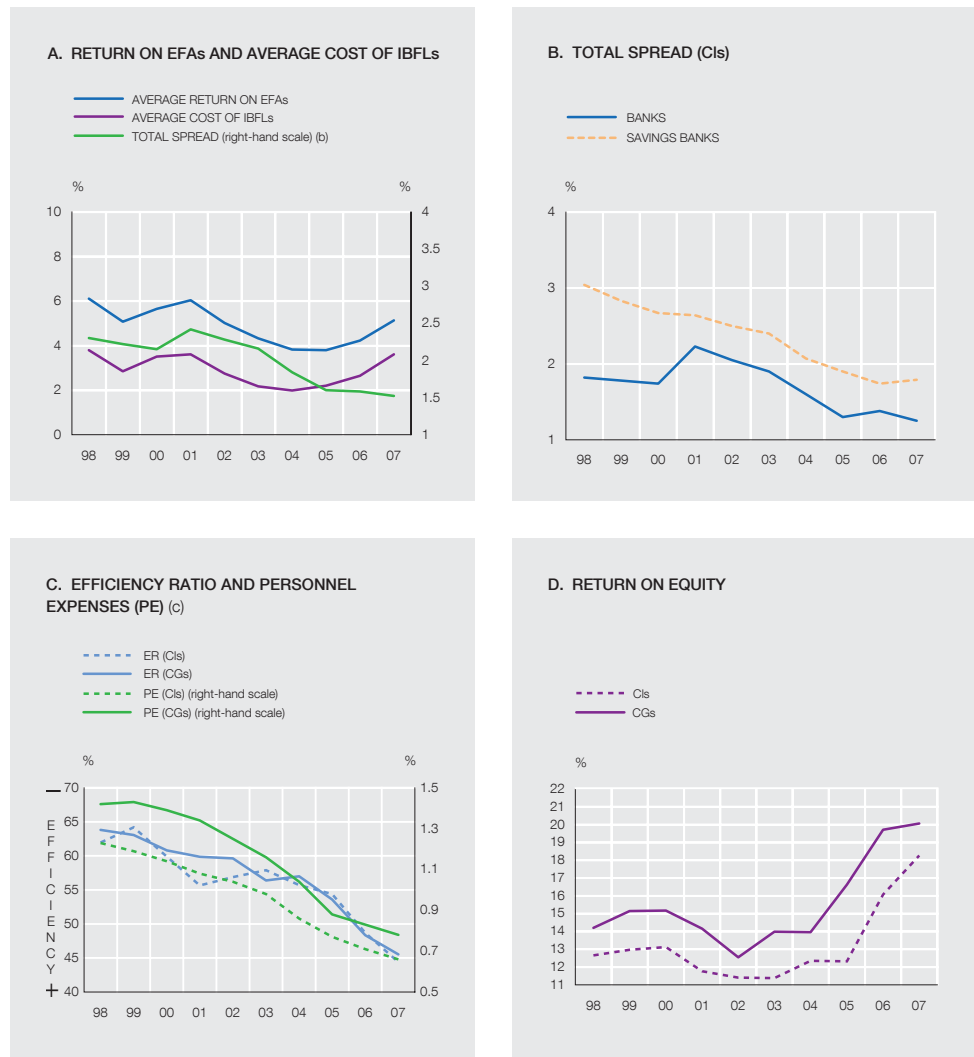
Non-interest income boosted the dynamism of net interest income, leading to a 21% increase in GI, which represented 2.51% of ATA (2.44% in 2006). Compared with a moderate increase

2. Defined as the spread between the average return on earning financial assets (EFAs) and the average cost of interest-bearing financial liabilities (IBFLs).

**RETURNS AND EFFICIENCY OF CREDIT INSTITUTIONS  
AND OF THEIR CONSOLIDATED GROUPS (a)**

CHART A.2.3

Yearly data



SOURCE: Banco de España. Data available at end-February 2008.

- a. The data in this chart refer to the institutions active at some time during each year. The label "CIs" denotes individual data, among which are included those relating to CIs not belonging to any CG.
- b. Total spread is defined as the average return on EFAs minus the average cost of IBFLs.
- c. The efficiency ratio is defined as operating expenses over gross income and personnel expenses are expressed as a percentage of ATA.

in net income from fees and commissions (+10.8%), the gains on financial assets and liabilities grew by 70.2%, this growth began driven by the sale of significant investments, with an increase of 125% in gains on available-for-sale assets. In relation to fees and commissions, which continued to be the most important component of non-interest income (they accounted for 0.53% of ATA as against 0.29% of gains on financial assets and liabilities) the 25% growth in those relating to securities service is notable, while at the other extreme, those corresponding to contingent exposures and commitments, which grew by only 3.2%.

Operating expenses, which include personnel expenses as their main item, maintained the moderate growth trend (10%) of previous years. This resulted in a further decline in this item relative to ATA, to 1.11% (down 8 bp from 2006). This drive to moderate the growth of operat-



ing expenses, and the positive developments in GI, made possible the improvement in the efficiency ratio mentioned above.

As a consequence of the favourable behaviour of GI and of the containment of operating expenses, net operating income grew by 30%, with a gain of 14 bp in terms of ATA, to 1.44%, which enabled the deterioration in the lower part of the income statement where provisioning expenses and write-downs are located to be absorbed relatively easily. Total provisioning expenses, write-downs and other grew by 66.4%, or 9 bp of ATA, owing to the losses arising from the deterioration in assets, and despite the decline in net provisioning expenses. In line with the foregoing, the profit before taxes of CIs grew by 23%, to stand at 1.13% of ATA (1.09% in 2006).

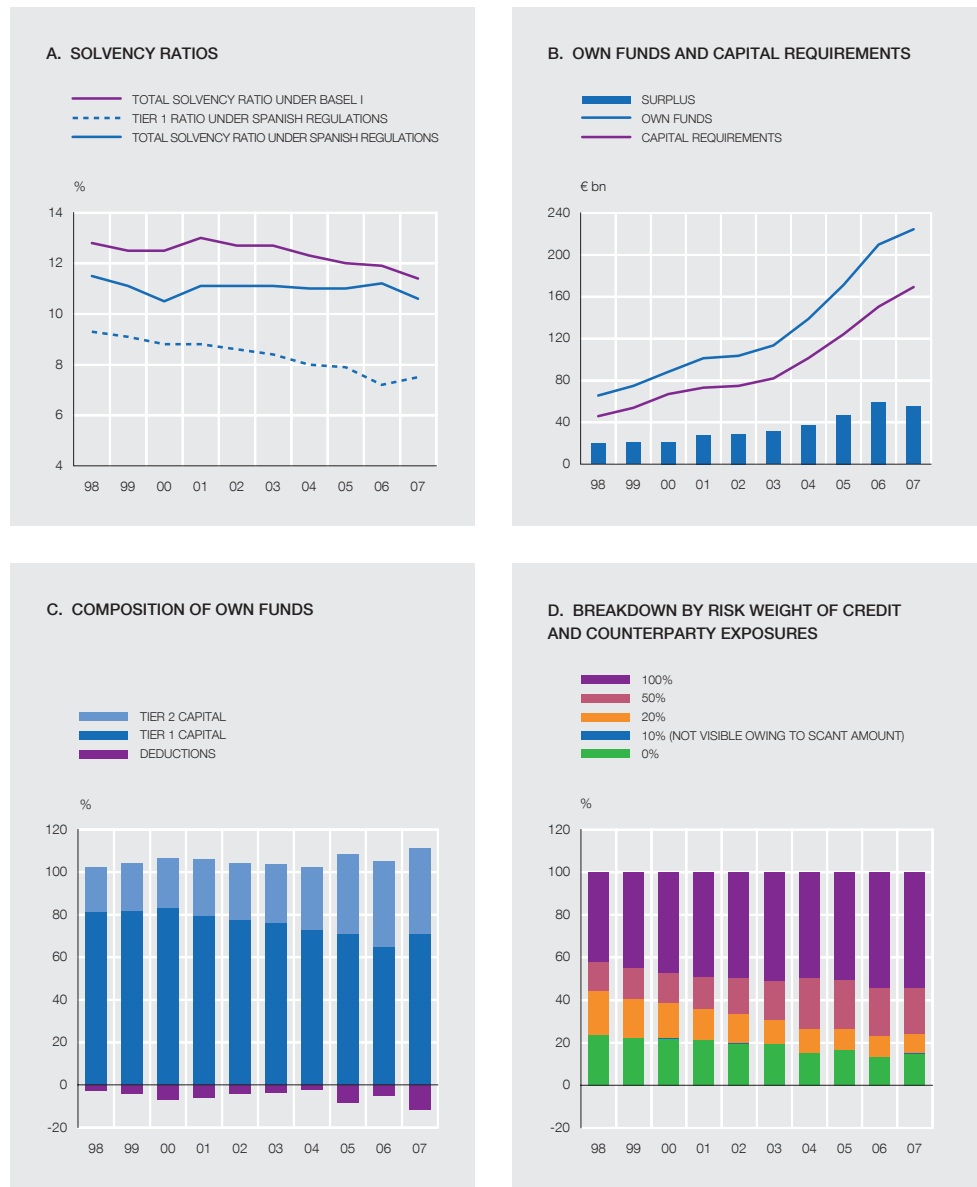
By institutional group, the main margins and profits displayed mixed behaviour (see Chart A.2.2 B). The financial income of savings banks increased by 54%, 20 pp more than that of commercial banks, and their financial costs increased by 68%, as compared with 51% in the case of commercial banks. As a result, while the commercial banks recorded a 9% increase in NII, which resulted in an 11 bp fall to 1.43% in terms of ATA, savings banks recorded growth in NII of 29%, which took this margin to 1.95% of ATA (up 12 bp from 2006). These differences in NII were passed through to the other margins, so that the profit for the period grew by 55% in the case of savings banks and 17% in that of commercial banks. In terms of ATA, savings banks increased their profit by 21 bp, to 1.01%, while the commercial banks increased theirs by 1 bp, to 0.95%.

The developments in the income statements of Spanish CGs were somewhat less positive than those observed for the CIs at the individual level, so that the gap that exists in favour of the CGs in the various margins of the income statement in terms of ATA (see Charts A.2.2 C and D) narrowed slightly. However, the efficiency ratio of CGs improved by almost 3 pp, falling to 45.5% (44.3% for CIs). The return on equity (ROE) increased by 0.4 pp to 20.1% (18.3% for CIs). The portion of profits corresponding to groups grew by 19.6%, to reach 1.01% of ATA, as against growth of only 2.6% in profit corresponding to minority interests.

In terms of ATA, all the margins grew in 2007, although at a slower rate than in 2006, except for net interest income which grew by 19.2%, with a rise of 4 bp in terms of ATA, to 1.75%. However part of this gain in terms of ATA was not passed through to GI, whose growth of 16.8% was translated into only 2 bp of ATA, as a consequence of the smaller contribution at the consolidated level of net gains or losses on financial assets and liabilities. The operating expenses of CGs behaved very similarly to those of individual CIs. Conversely, the negative impact of provisioning expenses, write-downs and other was greater for CGs than for CIs. Thus, the profit before taxes of CGs grew by 11.4%, as against 22.6% in the case of CIs. In terms of ATA, the profit before taxes of CGs declined by 6 bp, to 1.31%. Taxes on profits also fell at the consolidated level, enabling the profits of CGs to grow slightly, by 2 bp of ATA (10 bp in the case of CIs), to 1.05%.

Continuing with the comparison of the profits of CGs with those of CIs, it can be seen that the profits of commercial bank CGs had a more favourable impact than savings bank CGs. While the profits of commercial bank CGs rose from 1.05% of ATA in 2006 to 1.09% in 2007 (from 0.94% to 0.95% in the case of commercial banks), those of savings bank CGs fell from 1.03% to 1.02%. As a result, not only was the performance of the commercial bank CGs more positive, but also the level of their profits relative to ATA was higher, unlike in the case of individual CIs.

Year-end data



SOURCE: Banco de España. Data available at 18 March 2008.

a. The data in this chart refer to the CGs and to the individual Cis not belonging to any CG existing at year-end.

**3 Solvency of consolidated groups of credit institutions**

As at end-2007, CGs had eligible own funds of €224.4 bn, as compared with capital requirements of €169.2 bn, and consequently the solvency ratio calculated in accordance with Spanish regulations stood at 10.6%. This solvency ratio would have been approximately 11.4% had the Basel Accord (Basel I), which is in certain respects less demanding than Spanish regulations, been more strictly applied. Meanwhile, the decline that had been occurring in the tier 1 solvency ratio<sup>3</sup> was checked, and it recovered by 3 bp to 7.5%. Own funds grew by less than capital requirements (7% and 13%, respectively), so that surplus capital fell slightly (see Chart A.2.4 A and B).

3. The ratio of tier 1 capital (consisting mainly of capital and reserves) to capital requirements.

The slowdown in the growth of eligible own funds in 2007 occurred despite the 17.3% growth in tier 1 capital, and was a consequence of the moderate 7% increase in tier 2 capital<sup>4</sup> and, especially, of the sharp increase in the deductions applied to total own funds, which rose from €10.6 bn to €25.6 bn.

Tier 1 capital amounted to €159.5 bn and displayed positive behaviour thanks to the fact that the increase in disclosed reserves, along with the increase in the net reserves in consolidated companies, more than offset the increase in the deduction of consolidation goodwill. Thus, tier 1 capital rose to 71.1% of eligible own funds from 64.8% in 2006 (see Chart A.2.4 C).

In 2007, subordinated financing maintained the trend growth observed in previous years, rising by 10% to €44.4 bn, although its amount is still well below the limit of 50% of tier 1 capital.

Capital requirements increased by 12.5%, a slowdown from the increases of more than 20% in previous years. The weight of requirements for credit and counterparty risk increased to 95.8% of the total (94.9% in 2006). The decline of 20% in the requirements arising from trading book exposures calculated by standard methods was significant. This decline was not sufficiently offset by the increase in trading book requirements calculated using internal models.

As can be seen in Chart A.2.4 D, the distribution of exposures subject to credit and counterparty risk, according to the risk weightings applicable, was highly stable (see Chart A.2.4 D). However, it should be noted that an improvement was perceived in 2007 in the credit risk profile of CGs, since the average weighting of exposures fell to 66.8% from 67.4% in 2006, largely thanks to the growth of the group of exposures weighted at 0% at the expense of other weighting groups.

In CGs as a whole, the amount of large exposures subject to a limit<sup>5</sup> grew by 14% in 2007, although as a percentage of own funds, they declined to 57.9% from 60.9% in 2006. Also, on aggregate, the largest large exposures, taking for each CG the largest exposure to a third party borrower or economic group, reached 19.3% of own funds (as against the legal limit of 25%), while the total largest exposures to an unconsolidated entity belonging to the CG stood at 2.9% (as compared with the applicable limit of 20% of own funds).

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4. In 2006 tier 2 capital grew by 33% owing to certain regulatory changes. The entry into force of Banco de España Circular CBE 2/2006 of 30 June 2006 introduced two new elements of eligible tier 2 capital. After applying certain percentages, the gains (net of losses) on debt securities and on equity instruments classified as available-for-sale financial assets could be included in tier 2 capital. In addition, the provision on the entry into force of this Circular established that consolidated groups and individual institutions would be able to modify the December 2005 return to incorporate the new components. As a result, certain CGs recorded almost €6bn as tier 2 capital in 2005. However, the bulk of these gains were recorded in 2006, when they totalled €12 bn. In 2007, the gains remained practically unchanged and, therefore, made no contribution to the growth of tier 2 capital. The second of the newly eligible elements, the general loan loss provision, up to the limit of 1.25% of the exposures used as the basis for its calculation, grew by 10% in 2007, to €21 bn, which contrasts again with the 100% growth recorded in 2006. 5. Exposures to a borrower or group are considered "large exposures" when their value exceeds 10% of the CG's own funds. They may not exceed 25% of own funds when they are to a non-group borrower or group, or 20% in the case of all the unconsolidated entities belonging to the CG's economic group.

