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Banking Outlook

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Financial Systems Unit

- Developments in the Spanish banking sector: the recovery continues
- Bank issuance in the euro area: conditions are improving but there is still home bias
- Greek crisis: response from neighbouring banking systems
- Italian banks: still challenges ahead
- Lending in Spain: heading in the right direction
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Summary

1. Developments in the Spanish banking sector: the recovery continues

The stock of credit continues to decline, but the volume of new lending keeps growing. NPLs continue to moderate, on-balance sheet debt has fallen 16% in the past year and ECB funding has dropped by 64% from its highest level. Capital adequacy has been bolstered and institutions continue to build up their capital position. Profitability was affected during the crisis by provisioning and remains weak today. In 1Q15 the sector achieved a net profit of EUR3.027bn, which was 18% less than in the same period in 2014. Compared to the average for European institutions, Spanish banks are more efficient and have more on-balance sheet capital. On the other hand, the NPL ratio is higher. Profitability and NPL coverage are on the same level as the European average and the Loans/Deposits ratio is higher, although it has drawn closer to the European average since 2012 and currently stands at sustainable levels.

2. Bank issuance in the euro area: conditions are improving but there is still a home bias

Based on 800 debt issues carried out since January 2014, we note that the banks in the core countries within the euro area are issuing more than those on the periphery, and that most of the issuance is euro-denominated. Covered bond issues are those most used by periphery banks (49% of the total), while in core countries issues of unsecured senior debt predominate (43%). The main difference between the two sets of institutions is the price, which is higher among issues by banks in the periphery countries. Financing conditions have improved in all cases in 2015.

3. Greek crisis: response from neighbouring banking systems

The political situation in Greece came to a crossroads in late June, and the authorities in countries hosting subsidiaries of Greek banks took steps to head off contagion to their own banking systems in the event of the subsidiaries finding themselves forced to transfer liquidity or capital back to their parent banks in Greece. Among the measures taken were: greater capital requirements, banning outflows of money to Greece, and prohibiting purchases of Greek financial assets. The fact that offices of Greek banks abroad are subsidiaries rather than branches, helped to limit the contagion from Greece's domestic situation.

4. Italian banks: still challenges ahead

In the 2014 global assessment, nine Italian banks (out of 15) failed to make the grade and although several of them have already reinforced their capital positions, the capital buffers are tight. Moreover, NPL ratios continue to rise and in 2014 Italian banks did not break even in spite of bringing down their losses substantially. Efficiency is another pending challenge where improvement will be possible with a foreseeable consolidation process in the sector. Finally, the liquidity situation is comfortable, but the new regulatory requirements could mean a major challenge for banks whose funding relies heavily on deposits.

5. Lending in Spain: heading in the right direction

Given the situation of bank portfolios and the Spanish economy, the best-case scenario is what is happening at the moment: a fall in stock (-4.6% YoY in June) compatible with a rise in flows (+17.7% YoY for the cumulative figure from January to July). On the other hand, the cost of new loans has continued on its course of moderation and convergence towards the levels of the core countries in the euro area. For example, the average price of new loans to SMEs has come down by 1.8 percentage points in the past 15 months. After the crisis, lending should return to a more sustainable growth path, with a better balance between sectors.

6. Transposition of the BRRD: the final stage in establishing a fully-fledged resolution regime in Spain

On 20 June the new Law on Recovery and Resolution of financial institutions became effective (Law 11/2015 of 18 June). This step meant that Spain has culminated the process of transposing the EC Bank Recovery and Resolution Directive 2014/59/EU, better known as the BRRD. This invests the Spanish authorities with duties, tools and powers to conduct the resolution of banks in difficulties in an orderly manner, protecting their critical functions and avoiding an impact on taxpayers.

1 Developments in the Spanish banks sector

The tables and figures referred to are to be found in the annexes to this document. Most of the figures come from chapter 4 of the Bank of Spain's Statistics Bulletin. Examination of the Spanish banking sector is confined to banking business in Spain. The main conclusions regarding the current situation and recent developments in Spain's banking system are (Annex 1):

- Deleveraging of the system is continuing, with a 25% decrease in the overall lending volume since December 2008 (table 1). The rate of the fall in stock has been easing off given that the correction is reaching its conclusion.
- All the private-sector loan portfolios (Other Resident Sectors, ORS) have been considerably reduced in the last few years, with a drop in overall ORS loans of EUR512bn since 2008, which is 48% of GDP (table 4). The fall has been focussed on business lending, with a cumulative reduction in the total of 34% since 2008, and of 59% for the loan portfolio to real estate and construction companies.
- Total banking sector assets have come down by 12% during the crisis (table 1). This drop is smaller than that for lending due to the upturn in equity and fixed-income financial asset portfolios since 2008 (and especially the government debt portfolio). There has recently been a change in trend, as, since 1H14 the volume of these portfolios has dropped.
- The total volume of deposits has come down by 17% during the crisis (table 1). Nonetheless, resident private-sector deposits show greater stability (table 6), with a fall of 4% since 2008 and holding virtually stable in 1H15 compared to the same period in 2014. The largest falls can be seen in fixed term deposits, which are less appealing than other savings products such as investment funds in a climate of low interest rates.
- The volume of on-balance sheet debt issuance is still going down (-43% since 2008 and -16% in the last year to June) in line with deleveraging. At the same time, the interbank net balance (liabilities minus assets) has risen since the start of the crisis on account of the greater call on ECB liquidity by Spanish institutions given the closing-off of other sources of funds. This series shows a marked downward trend however, from the highs reached in August 2012 (-64% from the high). This is compatible with institutions making the most of the liquidity on good terms provided by the ECB in its targeted long-term refinancing operations (TLTROs).
- Installed overcapacity is still being reduced (table 3) in line with the contraction in business volumes and the quest for greater operating efficiency and banking profitability.
- On the other hand, the sector's capital adequacy has been notably enhanced. Own funds (common equity and retained earnings) have risen 25% (+EUR45bn) since December 2008 and capital quality has improved.
- The NPL ratio is still coming down despite the fall in its denominator, the total stock of credit (table 4). In June 2015 this rate had been brought down to 11.0%, its lowest level since April 2013. The doubtful loans volume has been falling off for 18 successive months and came down by EUR48bn from December 2013 to June 2015, of which EUR23bn took place in the first six months of the year. 44% of doubtful loans are to real estate and construction companies, which is a legacy of the crisis, and these should continue to diminish.
- The deleveraging of the stock of private credit is proving compatible with the flow of new lending (table 5). New transactions have shown a shift in trend since the end of 2013, and growth across all portfolios has been recently joined by the business loans over EUR1mn category, which is associated with larger

companies. These companies have been able to resort to other sources of funding during the crisis, such as markets or intra-group loans, yet, in the light of the attractive borrowing conditions, they are starting to apply for loans from the banks again.

- Several factors have had an adverse effect on bank results (table 2). Provision allowances (for losses on loan impairment, restructure costs and losses in value of foreclosed assets, mainly) have weakened profits since 2008 by USD293bn. On top of this the lower activity level, the deleveraging, the higher regulatory costs and the low interest rates have had negative effects. Since 2014 the trend has been changing and in 1Q15 a 5.6% increase in net interest income compared to 1Q14 was registered.
- Despite the fact that cost control remains one of the top priorities for the sector, operating income was reduced by 3.3% YoY in 1Q15 owing to the fall in net trading income. Provisioning continues to decrease in line with the improvement in the NPL ratio. Finally, pre-tax profit and profit after tax were pared down by 13% and 18% YoY respectively in 1Q15.
- Turning to the key management ratios (table 7):
    - Efficiency stands at an excellent level of 43.2% thanks to cost control. Notably, operating expenses as a percentage of total average assets have held below 1% since 2007 (figure 6, annex 1).
    - The sector's capital adequacy and liquidity position has improved significantly: the volume of regulatory capital (equity and reserves) reached 8% of the total balance sheet in June 2015, which implies leverage of 12.6x compared to a level of 18x in 2008. On the other hand, the sector has brought down the loans/deposits ratio to more sustainable levels, at 117%, which is 41 percentage points (pp) less than in 2008 (figure 3, annex 1).
    - The volume of on-balance sheet capital has held up throughout the whole crisis at over 100% of the volume of doubtful loans (figure 2, annex 1), and has risen since 2012 to 151%.
    - As can be seen from figure 4 of annex 1, deleveraging has given rise to a notable reduction of the system's funding gap (ORS loans less ORS deposits), and currently stands at 2002 levels, and a historical low as a percentage of the total balance sheet.
    - Finally, the indicators of the provisioning burden (provision allowances / operating income) and cost of risk (provisions / total lending) have returned to pre-crisis levels, which is a sign that provision requirements are returning to normal (figure 1, annex 1), which helps profitability to consolidate in positive territory after the losses in 2011 and 2012 (figure 5, annex 1).

With respect to how the Spanish banking system has progressed compared to the average performance by EU banks (Annex 2), the main conclusions may be summarised thus:

- The data used to carry out the analysis comes from the Risk Dashboard of the European Banking Authority (EBA) and is based on the average for 57 of the major banking institutions in the EU which took part in the European stress test in 2014. The latest available information is from December 2014.
- The principal positive aspects displayed by the Spanish banking system since late 2009 (the date from which EBA data is available) are a higher volume of on-balance sheet capital and a better efficiency level than European banks on average (figures 1 and 5, Annex 2).
- On the other hand, the most negative aspect is the trend in the system's NPL ratio, which is far higher in the Spanish banking system and shows higher growth. As has been mentioned earlier, the NPL ratio in Spain began to come down in January 2014, and has so far seen 18 successive months of falls.
- The increase in the NPL ratio and the substantial provisions required to turn round the system in 2011 and, above all, 2012, led to significantly worse profitability ratios than on average for EU banks (figure 4,

Annex 2). Nonetheless, since 2013 the profitability of the system has been on a par with that of European institutions on average. Streamlining of this kind was necessary in the Spanish banking system, as can be seen from figure 3 in Annex 2, which shows how exercises of this kind to turn round the system helped to achieve NPL coverage with specific provisions on a level similar to the European average.

- Finally, we can see from figure 6 of Annex 2 that the Loans/Deposits ratio in Spain is traditionally higher than on average in Europe, but from the end of 2012 the difference closes significantly, largely due to the transfer of assets to SAREB.

2 Bank issuance in the euro area: conditions are improving but there is still a home bias

Overview of bank issuance in 2014 and 2015

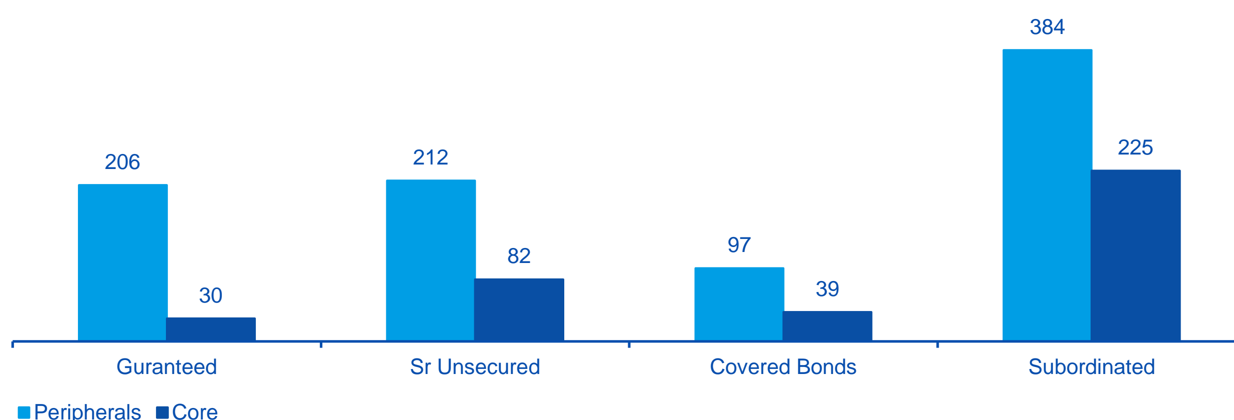
Based on data regarding approximately 800 bond issues made by banks in periphery countries (Spain, Italy, Portugal and Ireland) and core countries in the euro area (Germany, France, the Netherlands, Austria and Belgium) since January 2014, we can observe that the core euro countries are much more active than those on the periphery in capital markets. It can also be seen that most of the issues are in euros, especially among the periphery country banks (92% of the total) and not so much in the core countries (with "only" 65%).

Looking at euro-denominated issues:

- Both sets of banks account for approximately 80% of total issuance of senior unsecured debt and covered bonds. However, whereas 49% of bond issues in peripheral countries were covered bonds, among issues by banks in core countries it is senior unsecured debt issuance which predominates (43% of the total). The main reason for this is the low price of these senior unsecured issues, at slightly over 80 basis points (bp) above their domestic sovereign debt levels on average. The more limited use of covered bonds by banks in core countries reduces asset encumbrance relative to their competitors in peripheral countries, which have been forced to make more collateralised debt issues to access capital markets on acceptable terms.

- It is surprising that banks from core countries have made more issues of guaranteed debt (17% of total issuance) than those on the periphery (10%). Once again a clear difference can be seen in prices paid by institutions in both groups of countries.

Figure 1
Average price by issue type, 2014-15 (spread to treasury, bp)



Source: BBVA Research based on Bloomberg

- The price paid by core country institutions is significantly lower than that paid by banks in the periphery countries in all types of issues (figure 1). The difference is especially clear in the case of guaranteed issues (6.7 times more expensive in periphery countries) probably because with this type of issue a "country risk" premium is added to the particular risk attaching to the institution. The higher prices also arise from differences in the credit rating of the institutions, which is in most cases linked to the sovereign rating.

It should be stressed that the prices of issues are spreads over the rate on the Treasury issues of each country with a similar term to maturity rather than the interest rates on issues. Bearing mind the risk premiums for European government stock, the differences between the two groups of countries which we have referred to would be bigger if the issue rates were to be compared directly.

- The peripheral banks place their covered bond issues with a far lower spread than guaranteed debt, while this type of issue is the cheapest for core country institutions.
- By countries, Spanish and Irish institutions raise money on better terms than their Italian and Portuguese counterparts. Within the core countries, German, French and Dutch banks do so at lower prices than those from Belgium and Austria.

With respect to issues in non-euro currencies:

- Peripheral banks have only carried out 8% of their bond issues in other currencies since January 2014, all of these being in dollars and by Spanish and Italian banks.
- On the other hand, core country banks have issued 35% in other currencies, above all in dollars and sterling. This greater activity in foreign currencies underlines the greater receptiveness of international markets to the banking systems of core countries from the euro area.
- None of the institutions in the two groups of countries has issued covered bonds in currencies other than the euro since January 2014. On the other hand, all the issues of note programmes have been in dollars, and generally by core country institutions and on fewer occasions by Spanish and Italian banks. No issues of notes have been done in euros.

Improved borrowing conditions in 2015

Borrowing conditions among the peripheral countries have improved substantially in 2015:

- The conditions for issuance of senior unsecured debt and covered bonds have become more advantageous in all aspects: larger average size, longer term to maturity and a lower price.
  - Senior unsecured. Figures for 2015 (2014): Average size: EUR1.00bn (EUR0.60bn); Term: 5.31 years (4.35 years); Spread to treasury: 160bp (219bp).
  - Covered bonds. Figure for 2015 (2014): Average size: EUR0.91bn (EUR0.89bn); Term: 7.48 years (7.11 years); Spread to treasury: 66bp (110bp). Covered bond issues in periphery countries have reached 63% of the total in 2015 (44% in 2014).

The same conclusions can be drawn when analysing the banks from the core countries in the euro area, since they are issuing in better conditions in 2015.

- Senior unsecured (50% of total issuance in 2015). Figures for 2015 (2014): Average size: EUR0.94bn (EUR0.93bn); Term: 5.13 years (4.20 years); Spread to treasury: 78bp (86bp).
- Covered bonds. Figures for 2015 (2014): Average size: EUR0.68bn (EUR0.75bn); Term: 8.52 years (6.76 years); Spread to treasury: 31bp (42bp).
- As with the periphery countries, guaranteed and subordinated debt issues are far scarcer and the conditions for these have not changed significantly in 2015.

To summarise, conditions in international capital markets have become more benign in all cases, although there are still major differences in the conditions for raising funds that are obtained by the core and peripheral countries. In general terms, institutions from core countries issue at lower rates, over longer terms to maturity, and in a higher proportion of more advantageous forms of issue (senior unsecured).

3 Greek crisis: response from neighbouring bank systems

The political system in Greece has been deteriorating since the December 2014 elections, and reached a practically unsustainable situation at the end of June after the Greek government rejected the final proposal by the European institutions, called a referendum to decide on the proposal and announced the closure of Greek banks and capital controls.

In this context the monetary authorities of those countries where Greek banking institutions have subsidiaries began to take steps to head off contagion to their own banking systems. One of the risks considered to be a threat was that the subsidiaries of Greek banks would be forced to transfer liquidity or capital to their parent banks, although this was less likely given that the offices abroad of Greek banks are mostly subsidiaries rather than branches, which endows them with greater independence in terms of capital and liquidity.

Even so, from April the monetary authorities in Bulgaria, Albania, Romania, Serbia, Cyprus, Macedonia and Turkey began to bring in measures to oblige subsidiaries of Greek banks operating in their countries to limit their exposure to “Greece risk”, by cutting their bond, T-bill, deposit and loan portfolios in Greece to zero. Below we offer a brief summary of the steps taken by these countries:

Bulgaria:

- Weight of Greek bank subsidiaries: 28% of assets and 19% of GDP.
- Bulgaria’s central bank limited itself to making the point that the Bulgarian banking system is totally independent of decisions taken in Greece and that any decision by the Greek government regarding capital controls or of any other kind does not apply in Bulgaria and nor can it affect the functioning or stability of the Bulgarian banking system.
- It underlined that subsidiaries of Greek banks operating in Bulgaria have adequate capital and liquidity, and that no "assets receivable" exist in relation to any banking institution from Greece and nor do they hold any Greek sovereign debt securities.

Albania:

- Weight of Greek bank subsidiaries: 15% of assets and 18% of GDP.
- Albania’s central bank stresses that for some years now it has required stricter capital adequacy and liquidity ratios of Greek banking institutions than for the rest of the banking sector (14% versus 12% required of other institutions) and that the level for this ratio currently stands at 17%.
- According to the latest available data, the Albanian banking system does not have any exposure to Greek public- or private-sector assets.
- Attention is drawn to the fact that the measures taken in Greece do not in any way affect banking activity in Albania, and that Greek subsidiaries in Albania are to all intents and purposes Albanian (with foreign capital) which must operate subject to the standards and laws prevailing in Albania.

Macedonia:

- Weight of Greek bank subsidiaries: 20% of assets and 17% of GDP.
- The Macedonian central bank is taking a series of preventive steps of a temporary nature (6 months) to manage flows of funds in the country and avoid a flight of capital from the country which might affect Macedonia’s financial stability. The measures limit outflows of funds by residents in Macedonia (both natural persons and bodies corporate) destined for banking institutions in Greece from that moment onwards.

- The following limited transactions mentioned are, in their own words: exits of funds to Greece to set up companies, purchase financial assets (including investment funds), gold, credit facilities and long-term loans, etc.
- Likewise the following transactions not subject to limits are referred to: consideration for the exchange of goods and services, bank payments and charges relating to the purchase of goods and services involving residents of Greece and the payment of dividends to residents of Greece. The intention of the measure is to limit flows of funds from Macedonia to Greece, and not to obstruct current or future commercial transactions with Greek institutions.

- In addition to this, Macedonian banks are required to withdraw their funds and assets from banks that operate in Greece, as well as subsidiaries of these banks abroad.
- All Macedonian residents are prohibited from investing in securities of any kind issued by Greek companies or institutions, including the central government and local governments in Greece.

Serbia:

- Weight of Greek bank subsidiaries: 14% of assets and 11% of GDP.
- Serbia's central bank says that subsidiaries of Greek banks that operate in Serbia will be able to run their operations as normal and it stresses that local banking regulation is stricter than in Greece, for which reason such institutions have had to create capital buffers and generate liquidity in the last few years, which are to be used should the need arise.
- Since 29 June transactions between subsidiaries of Greek banks and their parent institutions in Greece have been limited, although no details of what these limits consist of have been provided.
- Notwithstanding this, explicit mention is made of the fact that those making deposits will not be affected.

Romania:

- Weight of Greek bank subsidiaries: 12% of assets and 8% of GDP.
- Romania's central bank has issued a statement in which it says that the level of capitalisation of subsidiaries of Greek banks is adequate (17%) and that they have ample portfolios of sovereign securities which qualify them to resort to the central bank for funding should the need arise.
- Notification is given that the authorities can take control of Greek corporations and find potential buyers in the event of a Grexit.
- A "compensation agreement" exists, which allows Romanian subsidiaries to refuse to attend to requests for the repatriation of any deposits that their parent institutions in Greece might make.

Turkey:

- Weight of Greek bank subsidiaries: 4% of GDP.
- The presence of Greek banks in Turkey is confined to Finansbank, which is owned by National Bank of Greece. The ECB could oblige NBG to speed up the sale of Finansbank, and Qatar National Bank had shown an interest in connection with this.

Given that the European Bank Recovery and Resolution Directive has only been transposed in three countries (Austria, Spain and Greece), there are no common rules on handling banking crises and the measures being taken now will probably have repercussions on managing future crises. In any event, the economies where Greek banks operate are better equipped to deal with a banking crisis than in the past and the exposure of these countries to Greece has receded notably in recent years.

4 Italian banks: still challenges ahead

The banks need to strengthen their capital

In the ECB's comprehensive assessment, Italian banks stood out in a negative sense, with nine banks (out of the 15 which participated in the exercise) failing to make the grade in the adverse scenario (EUR9.4bn) and eight doing so in the asset quality review (AQR) and in the baseline scenario. Although covering the capital requirement is not very much of a problem for most institutions (and these were actually covered in five cases in 2014), the capital buffers are fairly tight for several banks. Two of those which were failed (Banca Monte dei Paschi, BMPS and Banca Carige) carried out capital increases in 1H15.

At the end of 2014, the CET1 ratio on a system-wide level was 11.8% (which compares with an average of 12.8% for the euro area's significant banks) and this comes down to 11.3% (11.5%) for the fully-loaded CET 1 ratio. With respect to the leverage ratio, the Italian banks compare favourably with their European peers owing to their high risk-weighted asset density.

High NPL ratio, despite the fact that no asset price bubble exists

Despite the brighter economic environment, the NPL ratio has still not peaked. Since 2007, this has more than tripled, standing at 17.7% as of December 2014. The high level is due to: i) high exposure to SMEs, ii) very lengthy resolution times for problem assets due to a sluggish judicial system and a conservative policy as regards transfers to bad debts, and iii) a relatively strict definition of non-performing which also encompasses substandard and refinanced loans. In the first few months of 2015 the volume of NPLs continued to rise.

Given the volume of problem assets (around EUR350bn, 22% of GDP), the Italian authorities are looking at specific measures that might reduce them, such as setting up a bad bank. On top of this, the government passed a Royal Decree in June to facilitate and speed up the recovery of NPLs, as well as changes to fiscal law which will allow provisions to be tax-deductible in the year they arise rather than over five years, which is what currently applies.

Structurally modest profitability and efficiency

In 2014 the banks as a whole returned losses, although these were considerably lower than they had been in previous years. The RoE excluding goodwill impairment was approaching zero, which compares with -11% in 2013 and -1% in 2012. For the three largest banks, the 1Q15 results show improved profitability based on increased income flows and stable expenses, as well as a cost of risk that is significantly below its peak (though it remains high). Italian banks have room to improve their efficiency level, given the fragmentation in the sector.

Comfortable liquidity and funding position

The Italian banks have a sound deposits base, with a limited funding gap between loans and deposits, which places them in a comfortable position when it comes to responding to liquidity squeezes in markets. Returns on deposits have come down, but are higher than those offered within the Spanish banking system for example. Italian banks played an active role in the TLTROs, with take-up of EUR93bn in the first three auctions (1/3 of total funds), reaching total ECB funding of EUR165bn (4% of total assets) at the end of June 2015. Although liquidity and funding is not a problem in the short term, certain banks will run into difficulties in complying with regulatory requirements such as the MREL.

5 Lending in Spain: heading in the right direction

What pattern of events would be desirable for Spanish private sector credit? Given the situation of bank portfolios and the Spanish economy, the optimum scenario would exactly match the current situation: a fall in stock compatible with an increase in flows.

First, the stock of credit is still falling, as in June this showed a YoY reduction of 4.6%. Thus the inflow to the stock of credit (new transactions granted) is still less than the outflow (repayments and bad debts). This drop in stock is desirable for several reasons. On the one hand, the stock of credit is still far higher than that of other neighbouring countries, with a ratio to GDP of around 120% in Spain, compared to 95% for the euro area. On the other hand, loans to construction and real estate companies still represent 14% of the total, compared to a contribution to the economy's gross value-added that still languishes at 6%. The gradual reduction of lending of this kind, in many cases granted during the real estate boom, will still take some time. The deleveraging of the stock of credit is losing traction, however, as the rate at which it is falling has been slowing in comparison with that of -6.5% on average in 2014 or -12.1% in 2013.

Second, this deleveraging is proving compatible with the fact that the flow of new lending transactions is rising. And this is very positive, because it is these loans which are more important for economic recovery, because they are associated with current investment and consumption. Looking at the cumulative figure for January to July, new loans rose 17.7% YoY. On top of this, all the constituent portfolios saw positive growth. Of particular significance was the performance of loans to larger companies (+14.3%, which is approximated by transactions with a value of over one million euros). During the crisis such companies had chosen to borrow from other sources, such as wholesale markets or intra-group loans, yet with the better prevailing lending conditions they are turning to the banks again. That said, there is still some way to go in this direction, as this is from a low base, and new transactions for the YtD still only represent 41% of lending granted in the same period in 2008. If these growth trends for new business are kept up, our estimates point to the flow of new credit surpassing the outflow of credit towards the end of the year, which will be when the stock begins to grow.

These developments in stock and flows in relation to credit have been the norm in banking crises historically, as new transactions track the economic situation more closely, while the stock is more prone to inertia. On average, the stock only begins to grow two years after the trough in terms of consumption and investment, which rings true as regards our forecasts for Spain.

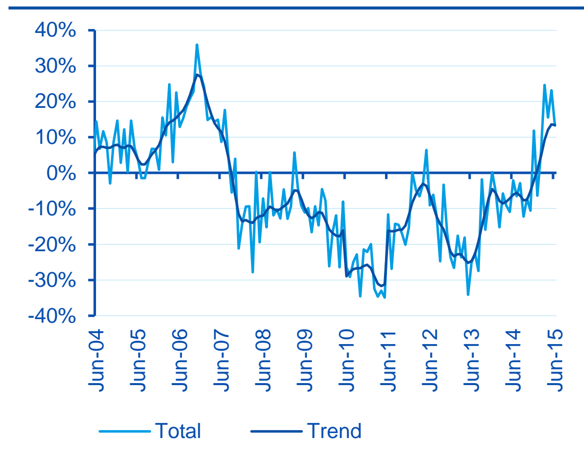
On the other hand, the cost of new loans has continued its trend of moderation and convergence towards the levels of the core euro area countries. First, this reduction of interest rates was brought about by the fall in Spanish sovereign risk, which translated into a lower cost of borrowing for banks that was passed on to customers. The stimulus of concerted Europe-wide measures, such as banking union or ECB monetary policy has been highly instrumental in bringing down sovereign premiums and thus improving conditions for Spanish households and businesses. Second, the easing of credit risk (reduction of the NPL ratio) is helping to make loans cheaper. As a result of all this, the average interest rate on new loans to SMEs has dropped by 1.8 percentage points over the past 15 months, shedding one third of its level, from 5.07% in March 2014 to 3.28% in June 2015.

Moreover, in Spain efforts are being made to encourage alternative or non-bank funding as a means to ease the private sector's reliance on the banking sector. Alternative funding (which covers sources such as the MAB, the MARF, venture capital, business angels, crowdfunding, etc.) can supplement bank financing in the initial stages of a project or for risky ventures. These alternatives are in any event regulated and supervised in much the same way as the banks are to maintain competition and reduce risks. Nonetheless, given that

non-bank financing is currently of a limited size (in 2014 it accounted for 0.8% of new banking loans), until this develops, the banks will continue to play a pivotal role in providing funding for the Spanish economy.

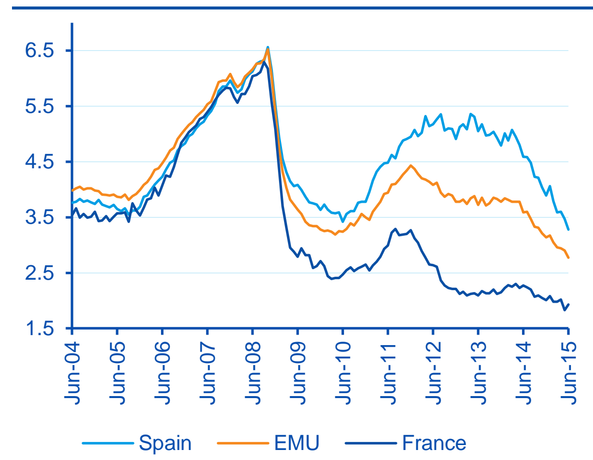
The strength of new bank lending is expected to continue in the next few quarters, for reasons relating to both demand and supply. On the demand side, the economic recovery, the progress made in the area of exports which a large section of businesses have made, and cheaper borrowing will encourage loan applications. On the supply side, the improvement seen in liquidity conditions (thanks to banking union and the ultra-expansionary policy pursued by the ECB), the lower portfolio risk engendered by the brighter economic situation and the headway made in banking restructure will all be positive forces. One of the paramount objectives of the banks is to encourage the recovery of new lending business. After the crisis, lending should return to a more sustainable growth path, with a better balance across sectors.

Figure 2
Spain: new lending volume (% YoY)



Source: BBVA Research based on the Bank of Spain

Figure 3
Interest rates on new SME loan transactions (up to EUR1mn and up to 1 year, %)



Source: BBVA Research based on the ECB

6 Transposition of the BRRD: the final stage in establishing a fully-fledged resolution regime in Spain

On 20 June the new Law on Recovery and Resolution of financial institutions (Law 11/2015 of 18 June) came into effect in Spain to replace Law 9/2012, which established the procedures for bank resolution in the context of the Financial Assistance Programme led by the European Commission, the European Central Bank and the international Monetary Fund in 2012. This step marks the culmination of Spain's process of transposing the Bank Recovery and Resolution Directive 2014/59/EU, better known as the BRRD.

This new law invests the Spanish authorities with an array of tools and powers aimed at tackling banking crises preventively, safeguarding financial stability and minimising taxpayer exposure in the event of bank failures. The law marks a decisive step in erecting a fully-fledged bank resolution framework on a nationwide basis, which is in alignment with international best practices and consistent with that of other member states.

The key elements of the new law are:

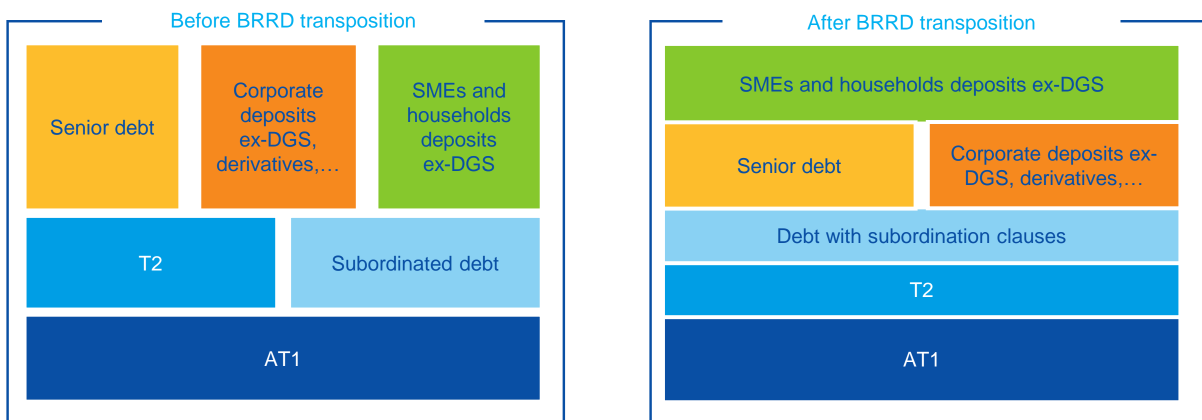
- A **jointly-led institutional model** will be established where the preventive role will fall to the Bank of Spain with back-up from the Single Supervisory Mechanism (SSM) and the Single Resolution Committee (JUR in Spanish) and resolution tasks at the executive phase will be undertaken by the Fund for Orderly Bank Restructuring (FROB in Spanish), likewise backed up by the JUR:
  - **Resolution duties at the preventive phase are entrusted to the Bank of Spain**, which will perform them via two operationally independent bodies. On the one hand, the Directorate-General for Supervision of the Bank of Spain, in conjunction with the SSM, will evaluate the recovery plans drawn up by the banks. On the other hand, the newly set-up Resolution Department at the Bank of Spain will chiefly develop the preventive resolution plans and assess and implement measures to mitigate hindrances to resolution, as well as set the minimum requirement for own funds and eligible liabilities (MREL) with loss-absorbing capacity.
  - **Resolution tasks at the executive phase are assigned to the FROB,** which will be in charge of deploying the various resolution tools (selling off the bank's business, transferring assets to a bridge institution or an asset management company and bail-in) when a financial institution goes into resolution.
- **Early intervention measures** whereby the supervisors are given a set of powers to intervene sufficiently early on and swiftly when an institution fails to comply with, or there are objective elements that mean it cannot comply with, the rules on capital adequacy, organisation and discipline. **Institutions must draw up and update a recovery plan on an annual basis** which covers measures and actions that must be taken to re-establish its financial position if this should become significantly impaired.
- The regulation completes the set of existing resolution tools for handling struggling banks (separation or sale of assets and the creation of a bridge bank), by adding the **bail-in** mechanism. This tool is one of the basic pillars of the new resolution framework and makes it possible to impose losses at all levels among the institution's creditors (including subordinated debt). The intention is for private shareholders and creditors not covered by the deposit guarantee fund to assume the institution's losses and eliminate or reduce injections of public capital into banks in a crisis situation.
- A **National Resolution Fund** is being set up which is funded by prior contributions from industry itself which must reach a minimum level of 1% of the guaranteed deposits of all the financial institutions. The Fund's main objective is to facilitate resolution of a bank by injecting capital, providing liquidity and/or purchasing assets, among other measures. Should the fund have to inject capital into a bank, there is a

prior requirement for shareholders and creditors to have assumed a minimum of losses via bail-in equal to 8% of the bank's total assets. From 1 January 2016, when the European Single Resolution Authority is fully operational, the National Resolution Fund will merge with the other National Funds in the euro area's member states to form a European Single Resolution Fund. Spanish institutions will then makes their contributions to this European Fund and the National Resolution Fund will remain exclusively for investment services firms.

Finally, to make the bail-in tool feasible and effective and reduce legal uncertainty, **Spanish law clarifies and homogenises the loss-absorption scheme under a resolution and insolvency process** (see Figure 1). The loss-absorption ladder establishes a level of seniority for retail deposits by SMEs and private individuals that comes above all other creditors:

1. Capital instruments (CET1)
2. Tier 1 instruments (AT1)
3. Tier 2 instruments (T2)
4. Debt with subordination clauses (Tier 3)
5. Senior debt and deposits over 100,000 euros by larger companies
6. Deposits over 100,000 euros by SMEs and private individuals

Figure 4
New creditor hierarchy after BRRD transposition



Source: BBVA Research

Annex 1: principal monitoring indicators for the Spanish banking system

Table 1
Abridged balance sheet for the banking system. (EUR bn and % var.)

Assets	2009	2010	2011	2012	2013	2014	2015	Date	Growth rate 00-'08	08-latest	y-on-y
Total lending	2,138	2,153	2,106	1,951	1,716	1,651	1.630	Jun-15	217%	-25.1%	-4.9%
Public corporations	*65*	*79*	*90*	*114*	*87*	*101*	*98*	*Jun-15*	*69%*	*84.6%*	*0.6%*
Domestic resident sector	*1,837*	*1,844*	*1,783*	*1,605*	*1,448*	*1,380*	*1.358*	*Jun-15*	*234%*	*-27.4%*	*-4.6%*
Non residents	*237*	*230*	*234*	*232*	*180*	*169*	*174*	*Jun-15*	*164%*	*-31.1%*	*-9.8%*
Fixed income securities and equity stakes	599	564	656	766	773	754	704	Jun-15	132%	41.5%	-9.9%
Fixed income securities	*415*	*384*	*406*	*509*	*493*	*492*	*459*	*Jun-15*	*135%*	*40.8%*	*-10.8%*
Of which: sovereign debt	*155*	*165*	*198*	*247*	*264*	*288*	*266*	*Jun-15*	*6%*	*164.8%*	*-9.3%*
Equity	*184*	*180*	*251*	*258*	*280*	*262*	*245*	*Jun-15*	*128%*	*42.7%*	*-8.1%*
Interbank lending	247	234	251	279	211	155	160	Jun-15	81%	-39.3%	1.4%
Other assets											
(net of interbank lending/deposits)	254	301	387	426	326	354	339	Jun-15	230%	18.0%	0.9%
Total assets	**3,238**	**3,252**	**3,400**	**3,423**	**3,026**	**2,913**	**2,832**	**Jun-15**	**184%**	**-12.2%**	**-5.2%**
Liabilities and Shareholders' Equity											
Customer deposits	2,015	2,031	1,934	1,725	1,684	1,686	1,666	Jun-15	169%	-17.3%	-2.1%
Public corporations	82	79	70	69	63	76	76	Jun-15	263%	-0.5%	2.9%
Domestic resident sector	1,427	1,440	1,373	1,317	1,314	1,289	1,276	Jun-15	192%	-10.9%	-2.8%
Non residents	507	511	492	339	306	320	314	Jun-15	113%	-37.8%	0.9%
Interbank deposits	305	270	373	573	381	312	317	Jun-15	95%	0.7%	-8.2%
Promemoria: net interbank position	58	36	122	294	171	157	158	Jun-15	215%	204%	-16.2%
Debt issued	434	433	435	394	297	249	227	Jun-15	625%	-42.6%	-16.0%
Other liabilities	294	340	439	535	430	436	396	Jun-15	253%	24.0%	-9.4%
Shareholders' equity	190	178	220	195	233	230	225	Jun-15	134%	24.8%	-3.1º%
Pro-Memoria: ECB funding	76	67	119	313	202	141	140	Jul-15	356%	120%	-13.1%
Total Liabilities and Shareholders' Equity	**3,238**	**3,252**	**3,400**	**3,423**	**3,026**	**2,913**	**2,832**	**Jun-15**	**184%**	**-11.5%**	**-5.2%**

Source: Bank of Spain statistics bulletin

Table 2
Abridged income statement for the banking system. Cumulative annual results (EUR mn and % var.)

	2009	2010	2011	2012	2013	2014	2015	Date	Growth rate 00-'08	08-latest	y-on-y
Net interest revenue	43,035	34,292	29,565	32,739	26,816	27,118	6,764	Mar-15	92%	-23.0%	5.6%
Net fees and commissions	12,163	11,870	11,750	11,275	10,931	11,257	2,810	Mar-15	79%	-13.7%	1.7%
Trading gaiuns and other revenue	12,354	17,151	15,811	15,493	17,797	17,043	4,770	Mar-15	276%	4.8%	-12.2%
Total revenue	**67,552**	**63,313**	**57,126**	**59,507**	**55,544**	**55,418**	**14,344**	**Mar-15**	**118%**	**-13.6%**	**-1.8%**
Operating expenses	-29,400	-29,431	-28,464	-26,951	-26,798	-26,116	-6,514	Mar-15	54%	-11.7%	0.2%
Personnel expenses	-17,742	-17,643	-16,889	-15,587	-15,108	-14,329	-3,534	Mar-15	54%	-21.0%	-3.0%
Other operating expenses	-11,657	-11,789	-11,574	-11,364	-11,690	-11,787	-2,980	Mar-15	54%	2.7%	4.2%
Pre-provision profit	**38,152**	**33,882**	**28,662**	**32,556**	**28,746**	**29,302**	**7,830**	**Mar-15**	**226%**	**-15.1%**	**-3.3%**
Loan-loss provisions	-19,551	-16,719	-22,668	-82,547	-21,800	-14,500	-3,386	Mar-15	620%	-11.2%	-5.8%
Other income, net	-4,234	-7,326	-23,430	-37,142	-2,789	-1,739	-752	Mar-15	-299%	142.6%	191.2%
Profit before taxes	14,367	9,837	-17,436	-87,133	4,156	13,063	3,692	Mar-15	108%	-27.6%	-13.0%
Net attributable income	**12,956**	**9,673**	**-14,717**	**-73,706**	**8,790**	**11,343**	**3,027**	**Mar-15**	**122%**	**-34.3%**	**-18.3%**

Source: Bank of Spain statistics bulletin

Table 3
Relative size, staff and installed capacity in the banking system (%, number and % var.)

	2009	2010	2011	2012	2013	2014	2015	Date	Growth rate 00-'08	08-latest	y-on-y
Lending to the private sector / GDP	170%	171%	166%	152%	138%	130%	126%	Jun-15	94%	-24.8%	-7.1%
Private sector deposits / GDP	112%	114%	111%	111%	112%	110%	108%	Jun -15	69%	1.9%	-4.3%
Number of employees	269,475	263,715	248,093	236,503	217,885	208,291	n.a.	Dec-14	14%	-25.2%	-4.4%
Number of branches	44,532	43,267	40,202	38,237	33,786	32,073	31,878	Mar-15	17%	-31.0%	-4.8%

Source: Bank of Spain statistics bulletin

Table 4

Breakdown of ORS loans, NPLs and NPL ratio by portfolio. (EUR bn, % and % var.)

Lending volume	2009	2010	2011	2012	2013	2014	2015	Date	Growth rate 00-'08	08-latest	y-on-y
Loans to households	**814**	**813**	**793**	**756**	**715**	**690**	**682**	**Mar-15**	**236%**	**-16.8%**	**-4.4%**
Of which:											
Housing loans	625	632	627	605	581	558	552	Mar-15	270%	-11.9%	-4.2%
Other loans to households	189	180	167	151	134	132	130	Mar-15	159%	-32.6%	-5.4%
Lending to corporates and SMEs	**1,000**	**1,013**	**971**	**830**	**719**	**674**	**676**	**Mar-15**	**237%**	**-33.5%**	**-5.2%**
Of which:											
Lending to real estate	453	430	397	300	237	200	195	Mar-15	517%	-58.6%	-15.1%
Other lending to corporates and SMEs	546	583	574	530	482	474	481	Mar-15	142%	-12.1%	-0.5%
Total lending to domestic private sector *	**1,837**	**1,844**	**1,783**	**1,605**	**1,448**	**1,380**	**1,358**	**Jun-15**	**234%**	**-27.4%**	**-4.6%**
NPLs											
Loans to households	**29.9**	**26.0**	**28.7**	**37.0**	**49.4**	**46.8**	**45.6**	**Mar-15**	**1062%**	**87.2%**	**-10.4%**
Of which:											
Housing loans	17.9	15.2	18.2	24.0	34.6	32.6	32.1	Mar-15	1878%	117%	-11.2%
Other loans to households	12.0	10.8	10.5	13.0	14.8	14.1	13.4	Mar-15	607%	41%	-8.4%
Lending to corporates and SMEs	**61.9**	**79.7**	**109.9**	**128.4**	**146.1**	**124.6**	**119.1**	**Mar-15**	**818%**	**219%**	**-15.3%**
Of which:											
Lending to real estate	43.6	58.0	81.9	84.8	87.8	70.7	66.4	Mar-15	2790%	147%	-21.0%
Other lending to corporates and SMEs	18.3	21.7	28.0	43.6	58.2	53.9	52.7	Mar-15	232%	406%	-6.6%
Total lending to domestic private sector *	**93.3**	**107.2**	**139.8**	**167.5**	**197.2**	**172.6**	**149.3**	**Jun-15**	**808%**	**137%**	**-19.8%**
NPL ratio											
Loans to households	**3.68%**	**3.20%**	**3.61%**	**4.90%**	**6.91%**	**6.78%**	**6.68%**	**Mar-15**	**246%**	**124.9%**	**-6.3%**
Of which:											
Housing loans	2.87%	2.41%	2.90%	3.97%	5.96%	5.85%	5.82%	Mar-15	434%	146%	-7.3%
Other loans to households	6.34%	5.97%	6.28%	8.63%	11.05%	10.71%	10.34%	Mar-15	173%	110%	-3.2%
Lending to corporates and SMEs	**6.19%**	**7.87%**	**11.32%**	**15.48%**	**20.31%**	**18.49%**	**17.62%**	**Mar-15**	**173%**	**380%**	**-10.6%**
Of which:											
Lending to real estate	9.62%	13.48%	20.63%	28.24%	37.05%	35.32%	34.11%	Mar-15	369%	496%	-7.0%
Other lending to corporates and SMEs	3.35%	3.72%	4.88%	8.24%	12.08%	11.38%	10.95%	Mar-15	37%	475%	-6.2%
Total lending to domestic private sector *	**5.08%**	**5.81%**	**7.84%**	**10.43%**	**13.62%**	**12.51%**	**11.00%**	**Jun-15**	**172%**	**226%**	**-16.0%**

(*)Total ORS loans includes household loans, total loans for productive activities, non-profit agencies serving households (ISFLSH in Spanish) and unclassified lending. Since January 2014 this has included loans to Financial Credit Institutions.
Source: Bank of Spain statistics bulletin

Table 5

Breakdown of new lending volume. Annual cumulative amount (EUR bn and % var.)

									Growth rate		
	2009	2010	2011	2012	2013	2014	2015	Fecha	'03-'08	'08-'14	y-on-y
Loans to households	150.6	123.4	74.3	63.3	51.2	60.7	48.1	Jul-15	0.7%	-67%	37.6%
Of which: Housing loans	73.2	69.5	37.5	32.3	21.9	26.8	19.9	Jul-15	-15.6%	-69%	27.7%
Other loans to households	77.5	53.9	36.8	31.0	29.4	33.9	28.2	Jul-15	21.3%	-65%	46.3%
Lending to corporates and SMEs	867.7	665.0	527.5	484.8	392.6	356.2	238.6	Jul-15	29.2%	-61%	14.4%
Of which: SMEs (loans < €1million	262.8	210.3	174.1	146.0	134.4	146.3	96.5	Jul-15	11.3%	-59%	14.6%
Corporates (loans > €1million	605.0	454.7	353.4	338.9	258.2	209.9	142.2	Jul-15	43.5%	-63%	14.3%
Total new lending flows	**1,018.3**	**788.4**	**601.8**	**548.1**	**443.9**	**416.9**	**286.,8**	**Jul-15**	**23.3%**	**-62%**	**17.7%**

Source: Bank of Spain

Table 6

Breakdown of resident deposits (EUR bn and % var.)

									Growth rate		
	2009	2010	2011	2012	2013	2014	2015	Fecha	00-'08	08-latest	y-on-y
Sight deposits	263	262	270	265	282	329	366	Jun-15	100%	49%	18.2%
Savings deposits	208	211	203	199	206	222	242	Jun-15	73%	16.4%	12.9%
Term deposits	720	744	698	684	668	588	535	Jun-15	270%	-26%	-16.5%
Deposits in foreign currency	22	19	18	20	21	22	22	Jun-15	527%	0.8%	8.2%
Total deposits of domestic resident sector *	**1,213**	**1,236**	**1,188**	**1,168**	**1,177**	**1,160**	**1,164**	**Jun-15**	**163%**	**-4.0%**	**-1.7%**

(*)Total ORS deposits does not match up with the data in Table 1 because the latter includes Asset transfer liabilities, Subordinated deposits, Rerpos and Hybrid instruments.

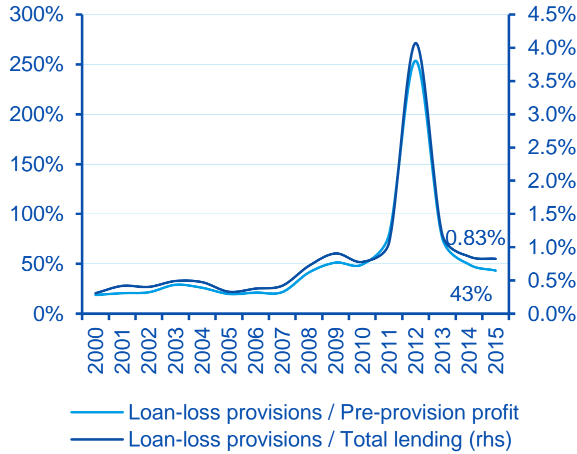
Source: Bank of Spain statistics bulletin

Table 7
Key ratios

	2009	2010	2011	2012	2013	2014	2015	Fecha	Growth rate 00-'08	08-latest	y-on-y
Productivity											
Business volumen* per employee (€'000 per employee)	11,317	11,679	11,974	11,725	12,050	12,195	n.a.	Dec-14	177%	11.2%	1.2%
Profit before tax per employee (€'000 per employee)	53.3	37.3	-70.3	-368.4	19.1	62.7	n.a.	Dec-14	82%	-14.4%	228.8%
Efficiency											
Cost-to-Income ratio (Operating expenses / Total revenue)	43.5%	46.5%	49.8%	45.3%	48.2%	47.1%	45.4%	Mar-15	-29%	2.2%	2.0%
Operating expenses / ATA	0.91%	0.91%	0.86%	0.79%	0.83%	0.88%	0.90%	Mar-15	-43%	-5.2%	4.9%
Profitability											
RoE	7.0%	5.2%	-7.4%	-35.5%	4.1%	4.9%	5.3%	Mar-15	-3.4%	-48.7%	-22.0%
RoA	0.44%	0.30%	-0.52%	-2.55%	0.13%	0.44%	0.51%	Mar-15	-24%	-22.2%	-2.6%
Liquidity											
Loans-to-Deposits (resident sector)	152%	149%	150%	137%	123%	119%	117%	Jun-15	15%	-26.2%	-3.0%
Funding gap (Loans - Deposits, resident sector, EUR bn)	624	608	594	437	271	220	193	Jun-15	349%	-71.8%	-19.19%
Funding gap / Total assets	19.3%	18.7%	17.5%	12.8%	9.0%	7.6%	6.8%	Jun-15	58%	-67.9%	-14.7%
Solvency and Asset Quality											
Leverage ratio (Shareholders' equity / Total assets)	5.9%	5.5%	6.5%	5.7%	7.7%	7.9%	8.0%	Jun-15	-18%	42.1%	2.3%
Shareholders' equity / NPLs	204%	166%	158%	117%	118%	133%	151%	Jun-15	-74%	-47.3%	20.9%
Provisioning effort (LLP / Pre-provision profit)	51.2%	49.3%	79.1%	253.6%	75.8%	49.5%	43.2%	Mar-15	121%	4.6%	-2.6%
Cost of Risk (Loan-loss provisions / total lending)	0.91%	0.78%	1.06%	4.07%	1.19%	0.86%	0.83%	Mar-15	134%	14.7%	5.2%
NPL ratio (resident sector)	5.08%	5.81%	7.84%	10.43%	13.62%	12.51%	11.00%	Jun-15	172%	226%	-16%
NPL coverage ratio (total)	58.6%	66.9%	59.6%	73.8%	58.0%	58.1%	60.0%	Jun-15	-58%	-15.3%	1.0%
NPL coverage ratio (specific provisions)	37.7%	39.6%	37.1%	44.7%	46.9%	46.7%	n.a.	Dec-14	-39%	56.2%	-5.9%

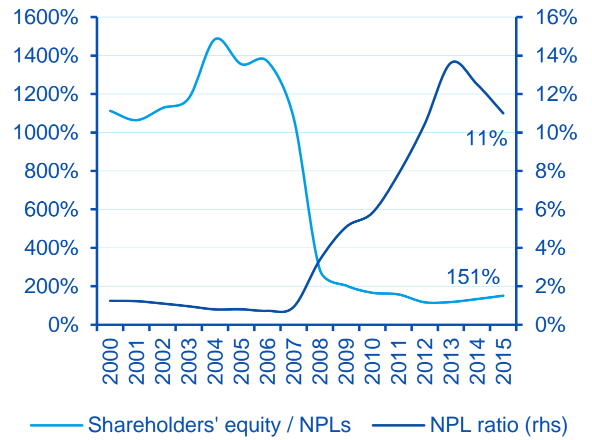
(*) ORS loans plus ORS deposits
Source: Bank of Spain statistics bulletin

Figure A1.1
Provisions



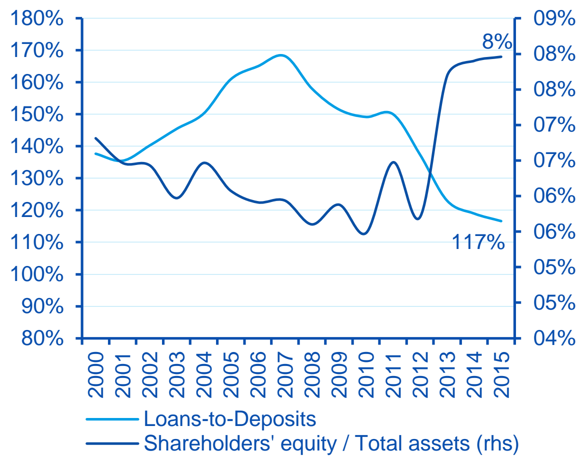
Source: BBVA Research

Figure A1.2
NPLs and Capital to NPLs



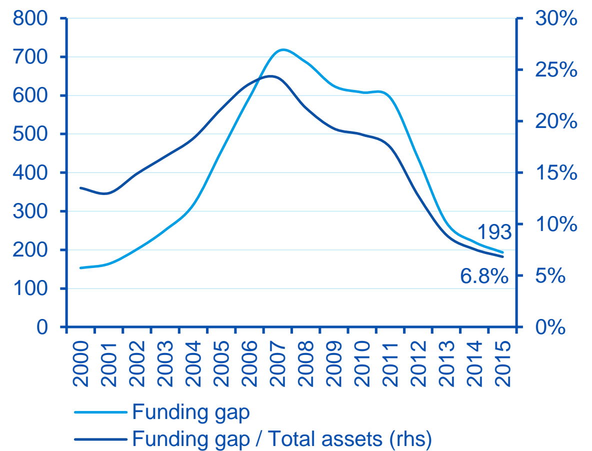
Source: BBVA Research

Figure A1.3
Liquidity and leverage



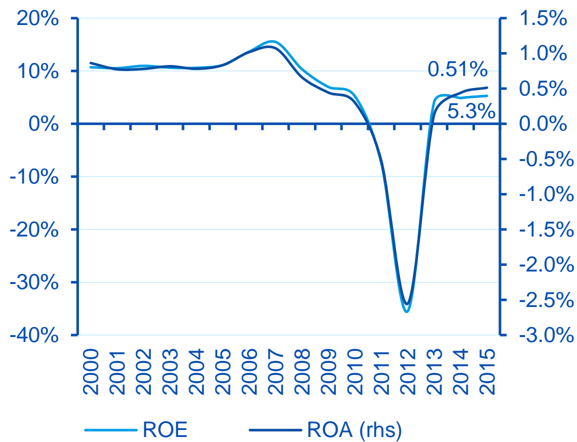
Source: BBVA Research

Figure A1.4
Funding gap (ORS loans – ORS deposits, EUR bn)



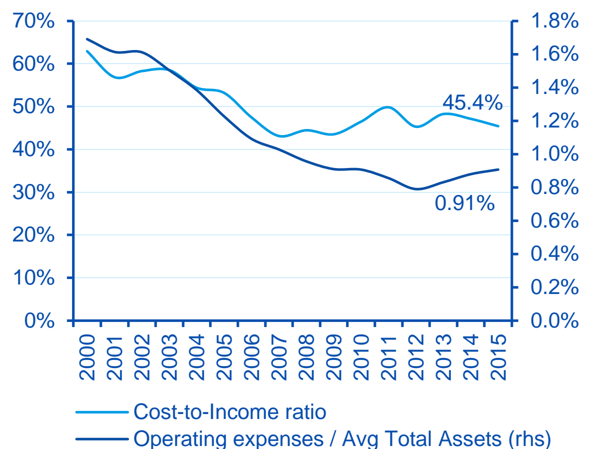
Source: BBVA Research

Figure A1.5
Profitability



Source: BBVA Research

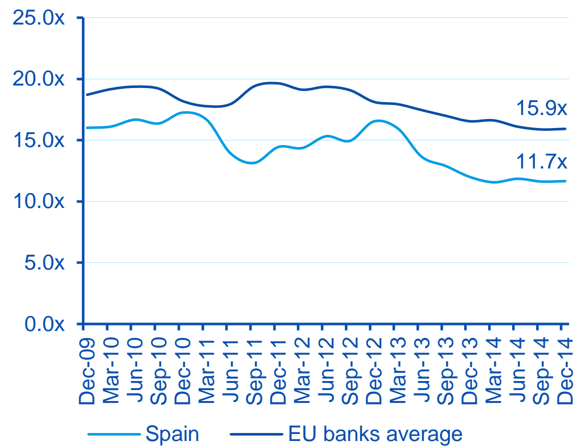
Figure A1.6
Efficiency



Source: BBVA Research

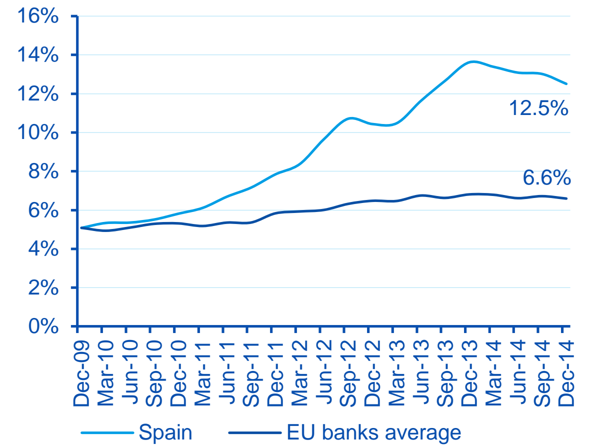
Annex 2: comparative analysis of the Spanish banking sector

Figure A2.1
Debt-to-Equity



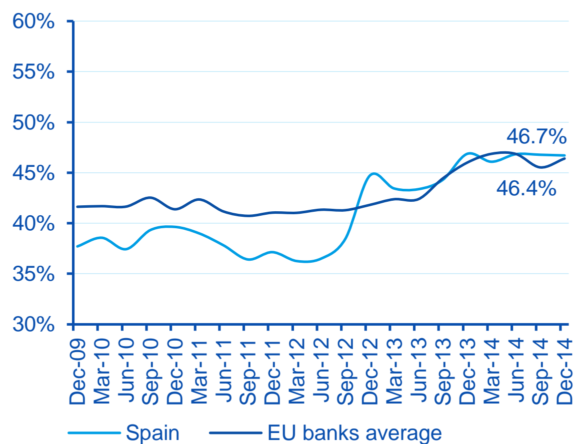
Source: EBA, BBVA Research

Figure A2.2
NPL ratio



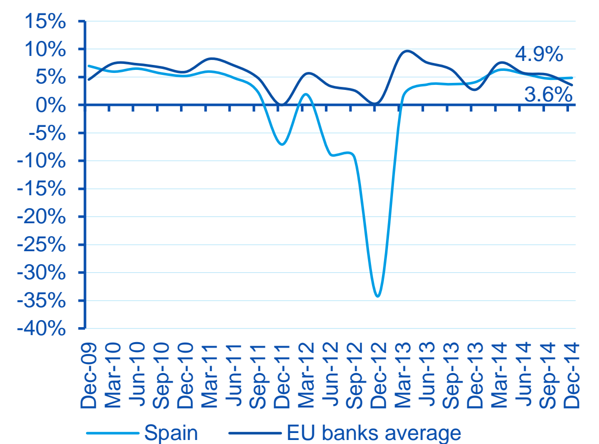
Source: EBA, BBVA Research

Figure A2.3
Coverage ratio



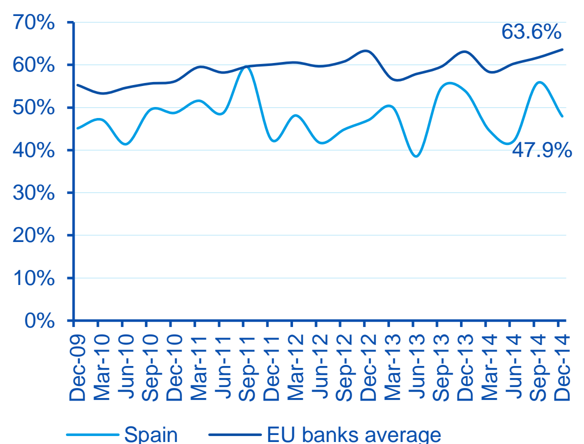
Source: EBA, BBVA Research

Figure A2.4
ROE



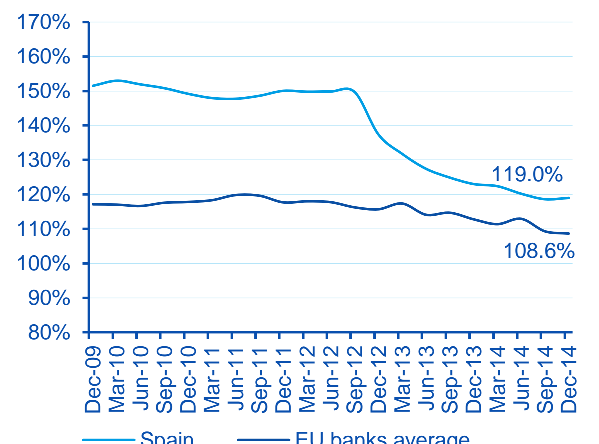
Source: EBA, BBVA Research

Figure A2.5
Cost-to-Income



Source: EBA, BBVA Research

Figure A2.4
Loans-to-Deposits



Source: EBA, BBVA Research

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