BBVA | RESEARCH

Banking Outlook

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Summary

1. Trends and developments in the Spanish banking sector

New lending to households and SMEs keeps growing despite the continued reduction in loans outstanding. The less positive aspect is the slight monthly increase in NPLs, the first in 35 months. Spanish' banks' profitability remains weak in spite of loan-loss provisions having returned to normal, but solvency was again reinforced. Net profit was €8,288 million in the first nine months of, 16% higher than in the same period last year due to lower taxes.

2. Variation in the net financial burden from 2008 to 2016

In general terms, Spanish homes have seen changes to their net financial income due to the joint effect of deleveraging and lower interest rates, which have freed up household resources on an aggregate basis. However, this adjustment has been offset by the drop in return on savings. The majority of these net savings were seen between late 2008 and the first quarter of 2010, a period in which interest rates plummeted, consumer spending dropped off significantly, the savings rate rose and investment collapsed.

3. The Portuguese banking system: relief at the DBRS rating

The DBRS rating agency has not reduced long-term Portuguese sovereign debt to junk bond status. Although this is good news, confidence in institutions and the implementation of new structural reforms are essential in order to strengthen a banking system that is currently rather unprofitable, with severe credit deterioration and progress needed in terms of capacity adjustment.

4. Banking union: necessary, positive and offering great potential

The global financial crisis made it clear that neither banks nor European institutions were prepared for a shock of this magnitude, a realisation that paved the way for the setting up of banking union. The European banking system was seriously fragmented, as could be clearly seen in liquidity and solvency trends and supervisory practices during the initial stages of the crisis. Banking union has already had significant benefits, such as alleviating the contagious effect of the banking crisis and the convergence of interest rates on loans, although in the future its effects will be even more important.

5. New package of banking reforms

The European Commission presented in November a new legislative package aimed at amending both the current banking prudential and resolution frameworks. The revision includes the implementation of several international standards into the EU law and the introduction of a package of technical improvements. In parallel, a legislative proposal to harmonise creditor hierarchy of senior debt across the EU has also been released. A negotiation period of approximately one year can be expected before a final text is agreed.

1. Trends and developments in the Spanish banking sector

The tables and data are to be found in the appendices to this document. The majority of the data come from Chapter 4 of the Bank of Spain's Statistical Bulletin. The analysis of the Spanish banking sector is confined to banking business in Spain. The following are the main conclusions on the current situation and recent trends and developments in the Spanish banking system (important: see footnote[1]):

Activity

- The size of the Spanish banking sector continues to shrink (see Table 1). The system's total assets fell by 4.9% over the twelve months to October 2016, and by 22% since their peak in December 2012. Since then, the size of the system has fallen by €759 billion (69% of GDP). This fall-off is reflected in the cut back to system capacity (see Table 3). The number of branches has been reduced by 36% since its high in December 2008. Figures from the close of 2015 show that the workforce has shrunk by 27% since then.

- The deleveraging of the private residential sector has continued since late 2008. However, despite the slow-down in 2016, fixed income and equity portfolios showed an upward trend since the beginning of the crisis, especially the sovereign bond portfolio, which has increased by 132% since 2008. Nevertheless, the latest figures as of October 2016 show that the fixed income portfolio has shrunk by 14% year-on-year (see Table 1).

- The total volume of system deposits (see Tables 1 and 6) has fallen by 22% since late 2008, although this drop-off has focused on volatile elements such as non-resident and subordinated deposits, repurchase agreements and hybrid instruments. More stable items (current accounts and savings and time deposits) have shown great steadiness, with an accumulated 3% fall since 2008. In any event, customer deposits remained flat over the past year, meaning that there was scarcely any sign of capital flight. Demand and savings deposits actually increased over the past year, due to the low profitability of other instruments in the current interest rate scenario (see Table 6).

- The debt issued by financial institutions is the liability item that has fallen the most, although increasingly slower (down 49% since late 2008, down 9% over the twelve months to October 2016. See Table 1). ECB liquidity has decreased by 68% since its high in August 2012. This is partly because institutions are taking advantage of the liquidity provided by the conditional auctions (TLTROs), as well as of that which they obtain in ordinary open market operations. Liquidity is no longer a problem for Spanish institutions.

- Finally, the percentage represented by on-balance-sheet equity capital continues to grow. With figures available to September, the volume of capital and reserves increased by 0.5% over the past year, up 27% (+€49 billion) since 2008 (See Table 1).

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

Spotlight on lending and NPLs

- The reduction in private resident sector credit stock has continued (see Table 4). In the twelve months to October 2016, Other Resident Sector credit fell by 4.8%, with an accumulated decrease of 32% since 2008 (€599 billion, 55% of GDP). The rate of this fall has slowed down since late 2013, indicating that deleveraging might be coming to an end soon. All resident sector loan portfolios have decreased, especially credit to construction and real estate companies, which have registered significant drops, down 9.3% over the past year. This item only represents 13% of stock, although it accounts for 37% of non-performing loans.
- Deleveraging is compatible with the dynamic nature of new lending to households and SMEs (see Table 5). In the first ten months of 2016, all credit portfolios registered notable growth, except loans to large companies (credit operations of over a million euros), which have access to other sources of financing such as debt issuance and saving. The 33% fall in new lending to major corporations from January to October is also due to a strong base effect in 2015. This trend has meant that the total volume of new credit operations fell 13.8% in 2016. Elsewhere, new lending to SMEs picked up slightly, while new lending to households posted accumulated growth of 8%.
- Despite the deleveraging of the economy, the delinquency rate for the system was reduced to 9.27% in October 2016 (see Table 4). In October the volume of NPLs grew slightly, the first monthly increase after 34 consecutive months of reduction. The accumulated drop in NPLs was of €79 billion or 40% from its peak in December 2013.

Results of the sector

- Sector revenues remain under pressure. Total revenue in the first nine months of the year dropped by 7.3% compared with the same period of 2015, with declines in all revenue lines (Table 2).
- Net interest revenue fell by 9.3% year-on-year to September due to low business volume and low lending rates that keep the cost of borrowing low (Table 7). Data to October 2016 show interest rates on new lending transactions down in all lending portfolios in year-on-year terms. However, compared with year-end 2015, rates for new loans to households have shown a slight uptick, whereas those for new loans to businesses have fallen further, especially for loans of more than €250,000. These reductions cannot be offset by cheaper deposits (Table 8).
- Operating expenses increased 0.7% year-on-year. Cost control, one of the defining features of the Spanish banking system, helped maintain the cost-to-income ratio at 53.7%, slightly worse than last quarter (50.5%) but still the benchmark in Europe. As a result, pre-provision profit fell by 17% year-on-year in the first nine months of 2016 over the same period last year.
- The most remarkable aspect of the system's results in January-September is the notable reduction in loan-loss provisions, which declined 35% year-on-year over the same period of 2015, in line with the improving NPL situation and the volume of balance sheet clean-up already carried out (€313 billion since 2008).

- Lower provisions resulted in flattish (-0.8%) pre-tax profit in the first nine months of 2016 over the same period last year, whereas net attributable income increased 16% year-on-year due to lower taxes in the second and third quarters of 2016.

- As regards the main ratios (Table 9):

  - As mentioned, cost-to-income remains slightly above 53% thanks to cost control and the improved levels of productivity (volumes and pre-tax profit per office). Operating expenses as a percentage of Average Total Assets have been held below 1% since 2008 (Figure 6, Appendix 1). This ratio's increase was due to the reduction in total assets.

  - Further improvement in the sector's solvency. The system's leverage ratio (capital and retained earnings over total assets) increased to 8.6% in October. Own funds on balance sheet almost double the volume of doubtful loans (Figure 2, Appendix 1), reaching 195% as of October 2016.

  - The loan-to-deposit ratio (the main indicator to monitor liquidity using public data) dropped further to 110% as of October 2016, 48 percentage points less than in 2008 (Figure 3, Appendix 1). The sector's funding gap (lending to, less deposits from, the domestic private sector) continues to narrow to all-time lows (€119 billion or 4.5% of total assets as of October) due to the deleveraging of the system and the stability of deposits.

  - System provisions remain at satisfactory levels. The provisioning "effort" (loan-loss provisions / pre-provision income) and cost of risk (loan-loss provisions / average total lending) indicators, are back at pre-crisis levels (Figure 1, Appendix 1), contributing to the consolidation of profitability following the losses of 2011 and 2012 (Figure 5, Appendix 1).

International comparison

If we compare developments in the Spanish banking system with the average of EU banks (Appendix 2), the following are the main conclusions of the analysis of the data from the "Risk Dashboard" of the European Banking Authority (EBA), which shows the average of 158 of the main EU banking institutions. The latest data available is from June 2016.

- Since late 2009 (when EBA figures became available) we can see that Spanish institutions are less leveraged than their European competitors (see Figure 1, Annex 2). To be specific, figures to June 2016 show a 39% increase in equity on the balance sheet, up from the 36% recorded in March.

- Efficiency levels are also 12.2% higher than the average for European banks (see Figure 5, Annex 2), an advantage that will last over time.

- The efforts that have been made to cleanse Spanish institutions were necessary (see Figure 3, Annex 2). Specific provisions to cover delinquent loans reached a similar level to the European average in mid-2014, and has remained above that level ever since.

- The delinquency rate continues to be higher in Spain, and grows faster than in other countries (see Figure 2, Annex 2). Nonetheless, the number of delinquent loans in Spain has fallen for 34 months consecutively. Trends regarding the rate are therefore related to their denominator, which is falling thanks to deleveraging.
- Finally, system yield is slightly lower than the European average (see Figure 4, Annex 2), something which would seem reasonable in an economy that has been hit so hard by the recession and in a sector which is still facing high levels of delinquency.

2. Variation in the net financial burden from 2008 to 2016

It is reasonable to assume that the current low interest rates in Europe will stay at similar levels for a long time. This situation, which has come about after an 8-year adjustment period, affects all stakeholders in the economy, both positively and negatively. We ask ourselves to what extent Spanish households have been affected, especially because of the way that the 12-month Euribor has fallen since its peak in late 2008. In general, Spanish families have benefited from low interest rates, which have essentially affected variable rates. Families saw the positive effect of a falling Euribor after a certain time delay. However, they have also been adversely affected by a poorer performance from their savings.

How have household income and expenditure changed?

In order to quantify this we need to analyse changes to the household financial burden, both in terms of mortgages and other debt, and in changes to income thanks to the accumulated savings in the household balance sheet. This analysis has two limitations:

- Aggregated debt and savings headings have been analysed and compared to analysis at a family level. Ideally this analysis should differentiate between families who are in debt and those that have savings, separating them into income and/or age bands. However, figures are not available for this.
- As far as the drop in the return on savings is concerned, it only includes the impact of lower interest rates on demand and term deposits. Income from other equity has not been taken into account, such as shares, pension funds and investment and debt funds, nor the transfer of assets from one to another in search of higher returns.

As well as the aforementioned fall in interest rates, analysis should also focus on the fact that in recent years, household indebtedness has decreased significantly. To September 2016, household credit stock fell by 20% from its high point in September 2010. There have also been changes as far as deposits are concerned – throughout this period, not only have they grown on an aggregate level but their make up has also changed, with demand deposits increasing at the expense of term deposits. The latter, which used to account for 60% of the total, now represent 35%.

Table 1

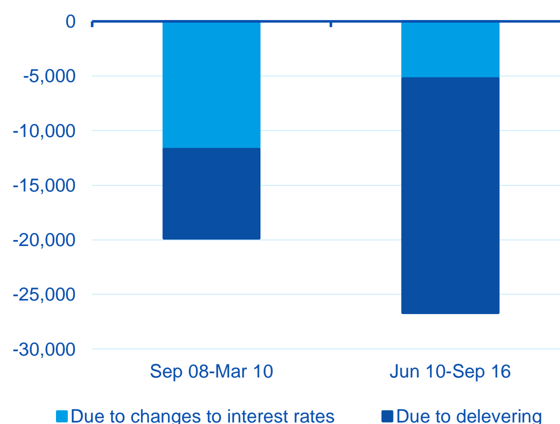
Variation in household income and expenditure – September 2008 to September 2016, € millions and % gross disposable household income (GDHI)

Expenditure			Income
Interest rate paid	-16,932	-22,520	Interest rate charged
(% GDHI)	-2.4%	-3.2%	(% GDHI)
Deleveraging	-29,610	792	Changes in stock deposits *
(% GDHI)	-4.3%	0.1%	(% GDHI)
Lower expenditure	**-46,542**	**-21,728**	**Lower income**
(% GDHI)	-6.7%	-3.1%	(% GDHI)
Freeing up of net income	24,814		
(% GDHI)	3.6%		

Source: BBVA Research based on Bank of Spain and INE

Figure 1

Variation in household income – September 2008 to September 2016, € millions and % GDHI



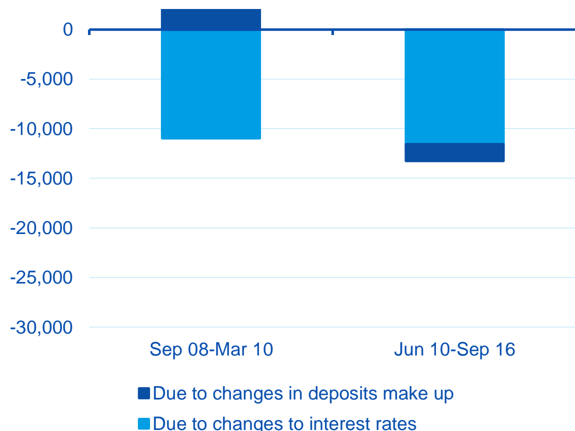
Source: BBVA Research based on INE

Since late 2008, Spanish families have seen their credit costs fall by almost 7% of their GDHI. Two thirds of this drop was due to deleveraging, with the other third the result of lower interest rates, freeing up nearly €47 billion of GDHI They have also seen income down 3% of GDHI, also due to lower interest rates. Families have therefore seen nearly €25 billion freed up, almost 4% of their GDHI (see Table 1).

The majority of savings in credit costs took place between September 2008 and the first quarter of 2010, a period when the 12-month Euribor fell more than 400 bps to 1.2%. From this point on, credit costs only fell as a result of deleveraging. Falling interest rates have more consistently been transferred to income over time (see Figure 2). However, it has to be borne in mind that for a period of time, Spanish institutions became involved in a "war for deposits", subsequently transferring part of their resources to more profitable products (promissory notes), which were not included in the analysis, meaning that household financial income and the changes thereto have been underestimated. The first phase of the process coincided with a period in which households cut their consumer spending, increasing savings which, to a large extent, was a precautionary move. This, together with the collapse in property investment, meant that Spanish homes went from needing credit to having capacity, using credit to accumulate financial assets: deposits and bonds mainly. Later, between 2010 and early 2011, families decisively reduced their borrowing.

Figure 2

Variation in household expenditure – September 2008 to September 2016, € millions and % GDHI



Source: BBVA Research based on INE

Table 2

Variation in expenditure based on debt type – € millions and % GDHI

	Expenditure of which:		
	total	for house purchases	consumer and other household credit
Interest rate paid	-16,932	-15,674	-1,258
(% GDHI)	-2.4%	-2.2%	-0.2%
Deleveraging	-29,610	-9,026	-20,584
(% GDHI)	-4.3%	-1.3%	-2.9%
Lower expenditure	**-46,542**	**-24,700**	**-21,842**
(% GDHI)	-6.7%	-3.5%	-3.1%

Source: BBVA Research based on Bank of Spain and INE

From the adjustment to expenditure, over 45% is the result of consumer credit and other types of non-mortgage financing, with families saving over €21 billion (see Table 2). The rest of the adjustment to expenditure is due falling mortgages, which have shrunk by almost €25 billion. Two thirds of this shrinkage is the result of lower interest rates.

To summarise, Spanish households have seen their net income change because a number of factors coincided. The joint effect of deleveraging and lower interest rates have freed up household resources on an aggregate basis, although this adjustment has been offset by the drop in return on savings. The majority of these net savings were seen between late 2008 and the first quarter of 2010, a period in which interest rates plummeted, coinciding with a drop in consumer spending, a rise in the savings and a collapse in investment.

3. The Portuguese banking system: relief at the DBRS rating

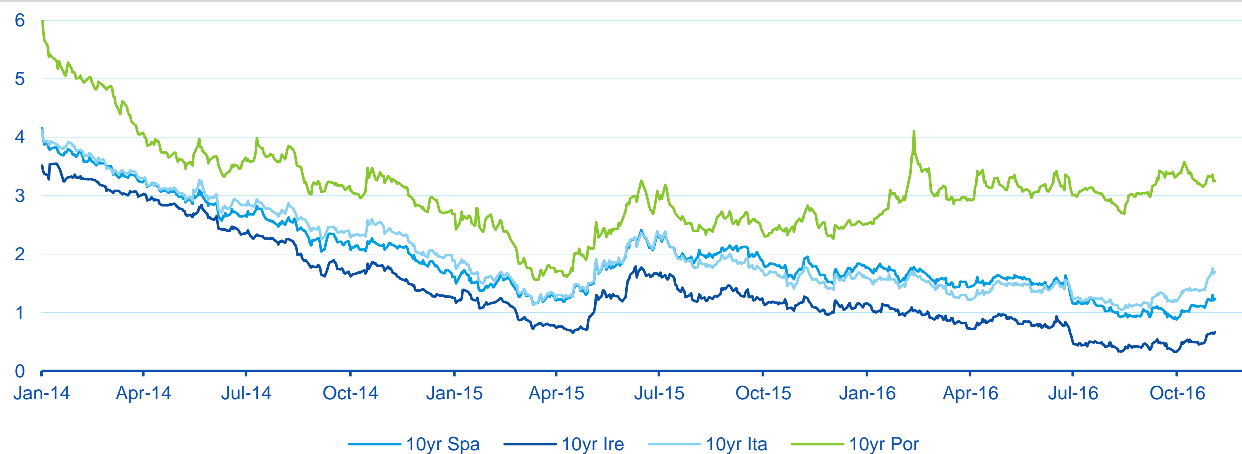
DBRS has confirmed that Portuguese debt has not been downgraded to junk bond status

On 21 October, DBRS announced that it would not be reducing the rating of Portuguese debt to "speculative grade", the only major agency not to do so. This is of great importance, as the state of Portuguese banking depends to a large extent on its sovereign debt not simultaneously being rated as speculative grade by the four leading rating agencies – DBRS, Fitch, Moody's and S&P.

This is essential if Portuguese banks are to continue to use their sovereign debt as collateral in ECB refinancing operations, allowing them to remain in the Public Sector Purchase Programme and ensure there is no significant upward pressure on the yield offered by Portuguese debt. As can be seen in Figure 1, over recent months the performance of 10-year sovereign debt has been worse in Portugal in comparison to Spain, Italy and Ireland. There are no signs of contagion, which may suggest that markets can distinguish more easily between the situation in countries in episodes that occurred before the financial crisis.

Figure 1

Yield on 10-year sovereign bonds (%) (%)



Source: BBVA Research based on Bloomberg

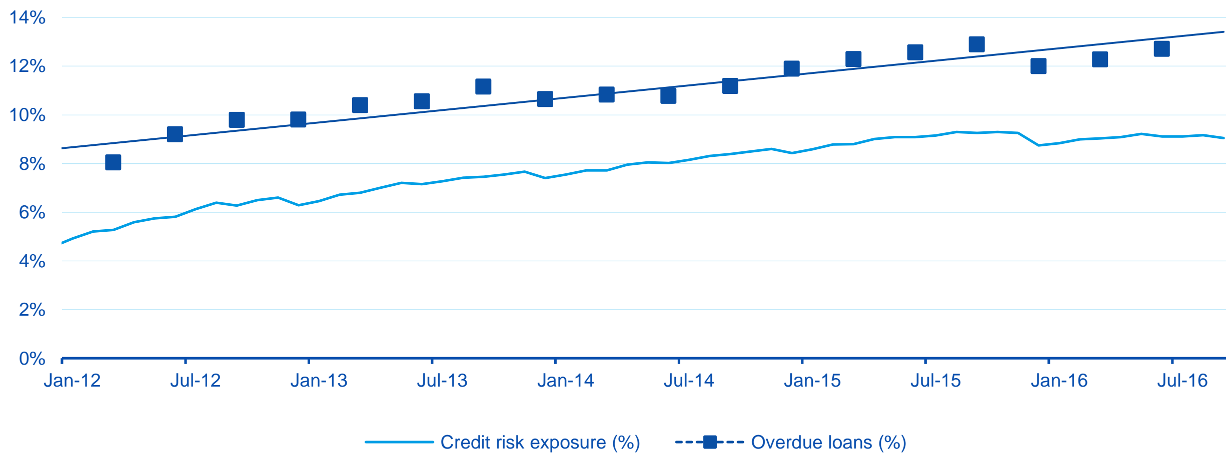
The situation in which Portuguese banks find themselves is yet to stabilise and is dependent on how the country's economy performs

Confidence in institutions and the implementation of new structural reforms are essential in order to strengthen a banking system:

- **One of the most concentrated in the Eurozone.** At the end of 2015, Portugal's banking system was still very concentrated in comparison to other major European systems. The market quota of the five largest banks is 69.6% (vs. 60.2% in Spain). There are areas of uncertainty inherited from the financial crisis, such as the consolidation of the banking system which has yet to be resolved, the state-rescued Novo Banco is looking for a buyer, there has been a takeover bid from BPI and Banif has just been sold.
- **This may go further than just capacity adjustments.** According to the ECB, between 2012 and 2015, the number of employees shrank by 8% (compared to shrinkage of 16% in Spain and 19% in Greece), while the number of branches dropped by 11% (-18% in Spain and -30% in Greece). Adjustment is not therefore particularly intense.
- **The private credit sector continues to contract** (down 3% YoY, Oct 16), **although private sector deposits are recovering slowly** (up 3% YoY, Oct 16). Eurosystem financing stands at €23.5 billion (down 1% YoY, Oct 16), a figure which is much lower than the more than €50 billion in 2012 during the implementation of the measures agreed upon with the rescue programme.
- **Worsening efficiency.** The cost-to-income ratio has increased since its low point in early 2015 (51%) to 63% the second quarter of 2016. Despite the reduction in operating costs, the fall has been greater on the revenue side. This contrasts with the figures for banks in Spain (51%) and Greece (52%), although it is better than in Italian and French banks (68%) or banks in Germany (71%).
- **Low yield.** According to the Bank of Portugal, the domestic ROE for the first six months of 2016 stood at 0.3% YoY (compared to 6.3% in the first half of 2015). Similar, the ROA was 0% YoY (compared to 0.5% for the same period the previous year). This lower yield is due in part to poorer financial transaction results and the exceptional figures for the first six months of 2015. Portuguese banks also have ongoing foreign operations, above all in Angola, which have improved their profitability.
- **The lower quality of assets is also yet to be resolved.** Since early 2012 there has been a progressive deterioration in credit quality (see Figure 2), something which is evident in the monthly delinquent loan rate, calculated based on the definition of due loans (9.1% in 2Q 2016) and the quarterly ratio based on credit risk exposure (12.7% in 2Q 2016), with a stricter classification, although one which is more comparable with other European figures.
- **Concerns over solvency.** The consolidated CET1 ratio continues to fall to 11.6% (2Q 2016). Its institutions have not been subject to the European stress test made public in late July, leading to speculation. Caixa Geral, Portugal's biggest deposit-taking institution, has just had a further recapitalisation approved.

Figure 2

Non-performing loans – (overdue loans and credit risk exposure) / total gross credit (%)



Source: BBVA Research based on Banco de Portugal

In short, although it is good news that DBRS has not downgraded Portugal's credit rating, the situation its banks are experiencing is some way off being described as sound and new measures will be required in the future.

4. Banking union: necessary, positive and offering great potential

The global financial crisis that has lasted since 2008 until today has also had positive consequences. One of these has been making it clear that neither banks nor European institutions were prepared for a shock of this magnitude. Since then, the European banking sector has witnessed one of the greatest transformations in its history, which has included the creation of Banking Union.

Banking Union is a key element of Economic and Monetary Union (EMU), harmonising regulation and assigning responsibilities in terms of supervision, resolution and credit. If EMU involves coordinating economic and budgetary policy, why wasn't the response to the banking crisis coordinated, bearing in mind the important budgetary repercussions that were at stake? Furthermore, if monetary policy were truly common, how could the regulation and supervision of banks – the main agents of this policy – be so different across the member states?

At the time of the crisis the banking system had significant shortcomings which made Banking Union necessary. A good example of the fragmentation that characterised banking in the EMU was the evolution of liquidity. One of the main effects of the arrival of the financial crisis to Europe was the practical disappearance of activity on the European interbank market, including between central countries, which was replaced by ECB liquidity.

Doubts regarding the banks that were most affected by the crisis also spread to the retail banking segment, with a number of institutions fearing capital flight. In order to prevent this, a number of European countries announced that they would be increasing the cover limit for each depositor and bank through the national deposit guarantee funds, generally up to one hundred thousand euros.

Some supervisors tended to increase the protection afforded to banks, even requiring that parent banks in some countries reduce the liquidity given to their foreign subsidies and branches, generally in eastern Europe, making the launch of the Vienna Initiative necessary.

In terms of solvency, neither the pre-crisis situation nor the evolution of capital ratios over the following years could be said to be similar. The initial reaction of some countries was to tighten up requirements, at least for certain kinds of institutions. The banks themselves also made an important effort to increase their capital ratios. However, in the case of peripheral countries, this was more difficult given the battered state of their economies and the hit that markets took.

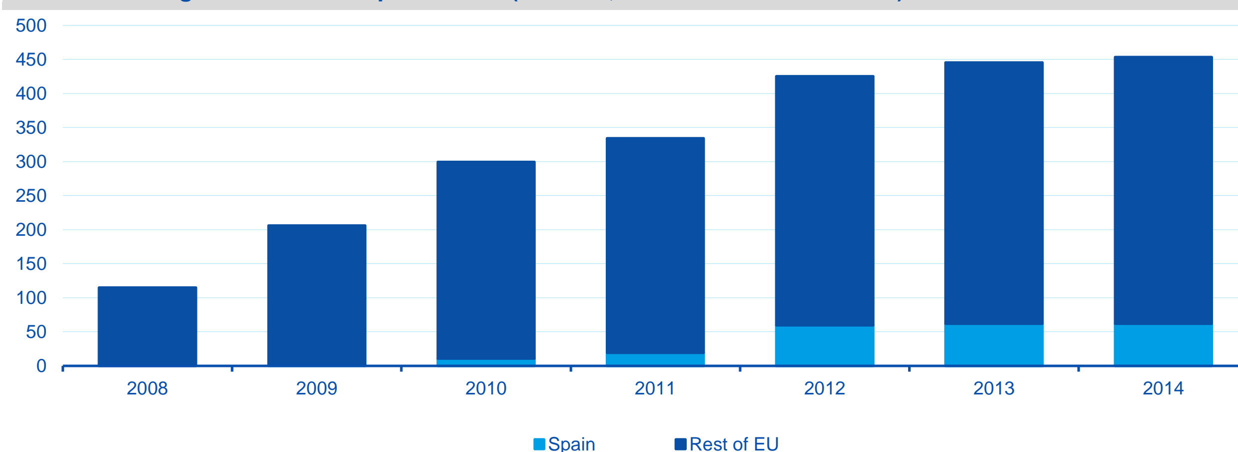
Occasionally, banks were the recipients of public recapitalisation that helped them achieve their solvency targets; again, this differed from country to country. Initially, bank rescues were decided on a case-by-case basis at the so-called “resolution weekend ” by local authorities without any common criterion.

In short, the European financial system at the start of the crisis seemed more like a plethora of domestic systems than a single European system. In such conditions, conflicts did not take long to materialise, further highlighting the need for an important change that would reduce fragmentation and increase stability in European institutions.

One of the main aims of Banking Union was to make a further financial crisis less likely and limit any possible consequences. Its impact can be clearly seen in the lower level of market fragmentation. It was not until 2012, with the introduction of Banking Union and the ECB's announcement that it would do “whatever was necessary” to defend the euro, that fragmentation started to moderate.

Figure 1

State aid during the crisis: Recapitalisation (€ billion, accumulated since 2008)



Source: European Commission

One of Banking Union's successes has been the reduced contagion of banking crisis among the various European countries. An example of this can be seen in the two Greek financial crises, where there was no contagion on peripheral banks during the second crisis.

The reduction in European fragmentation can also be illustrated by the convergence of interest rates, thanks to the reduction of rates in peripheral countries from 2012 onward, when the vicious circle of banking-sovereign risk began to ease off.

The carrying out of common stress testing by European authorities and the unification of supervisory practices, especially since the ECB became the single European supervisor, have helped to ensure that the perception that markets had of institutions now depended more on their fundamentals than on the countries in which the parent banks were based.

While Banking Union has been a significant step forward for European banking systems, some of its effects will cease to be noted when all pending measures have been implemented (such as the creation of common deposit insurance for the Banking Union), when a certain time has passed to allow the measures in force to bear fruit or when economic recovery means that all benefits can be reaped.

Ideally, real banking union would include transnational bank mergers. If the obstacles to setting up in other countries could be reduced and the regulatory framework standardised, it would be reasonable to expect that those banks in the best situation would want to expand in order to operate in other markets.

In summary, the financial crisis made it clear that Banking Union was needed, the effects have been positive and we can expect they will be even more so in the future.

5. New package of banking reforms

Content and timing of the proposal

The European Commission presented on 23th November a new comprehensive package of reforms to further strengthen the resilience of European banks. The package of measures includes the implementation of outstanding international standards and, at the same time, certain amendments to take into account European specificities or unintended consequences identified in the Call For Evidence. This is in line with the defined roadmap for completing the Banking Union which established that bank's risk reduction was needed before moving forward. The spirit of the Capital Markets Union is also present as the Commission wants to ensure that strong banks continue to play a key role in supporting growth and financing the economy.

The scope of this revision is double:

1. **Prudential framework**: the Capital Requirements Regulation (CRR) and the Capital Requirement Directive (CRD IV) are amended to introduce international standards and technical improvements.

   a) Main changes in CRR include:

   - A mandatory **leverage ratio** of 3% of Tier 1 aimed at preventing excessive leverage and at acting as a backstop to internal model-based capital requirements. No buffer for GSIBs has been included.
   - Implementation of the **Net Stable Funding Ratio** (NSFR), to promote a sustainable funding structure, with some adjustment from Basel so as to adjust to European specificities.
   - Specification of the **Minimum Requirement for Own Funds and Eligible Liabilities** (MREL) for global systemically important banks (G-SIBs). It will be determined on a case-by-case basis for the rest of entities.
   - A new standardized approach for measuring **counterparty credit risk exposure**, that replaces the Current Exposure Method and the Standard Method, aimed at increasing risk-sensitivity in non-internal models.
   - Implementation of the **Fundamental Review of the Trading Book** (FRTB), including modifications to both the standard and internal approaches and a new definition of trading desk.
   - New rules for exposures to **central counterparties** (CCPs) and the treatment of default funds in both qualifying and non-qualifying CCPs.
   - New framework for **equity investment in funds**, with revised conditions for the use of the different methods allowed.
   - Implementation of the new **Large Exposure Framework**, which includes: i) a new capital base (Tier 1 instead of eligible capital), ii) a hardened requirement for exposures of a G-SIB to another G-SIB (limit set at 15% of Tier 1) and iii) a final provision requiring that sovereign exposures incurred from November 2016 are subject to this framework (with a phase in period of three years).

- New **disclosure requirements**, to enhance consistency with the new Pillar 1 and ensure a proportionate application of these requirements.

b) Main changes in CRD IV include:

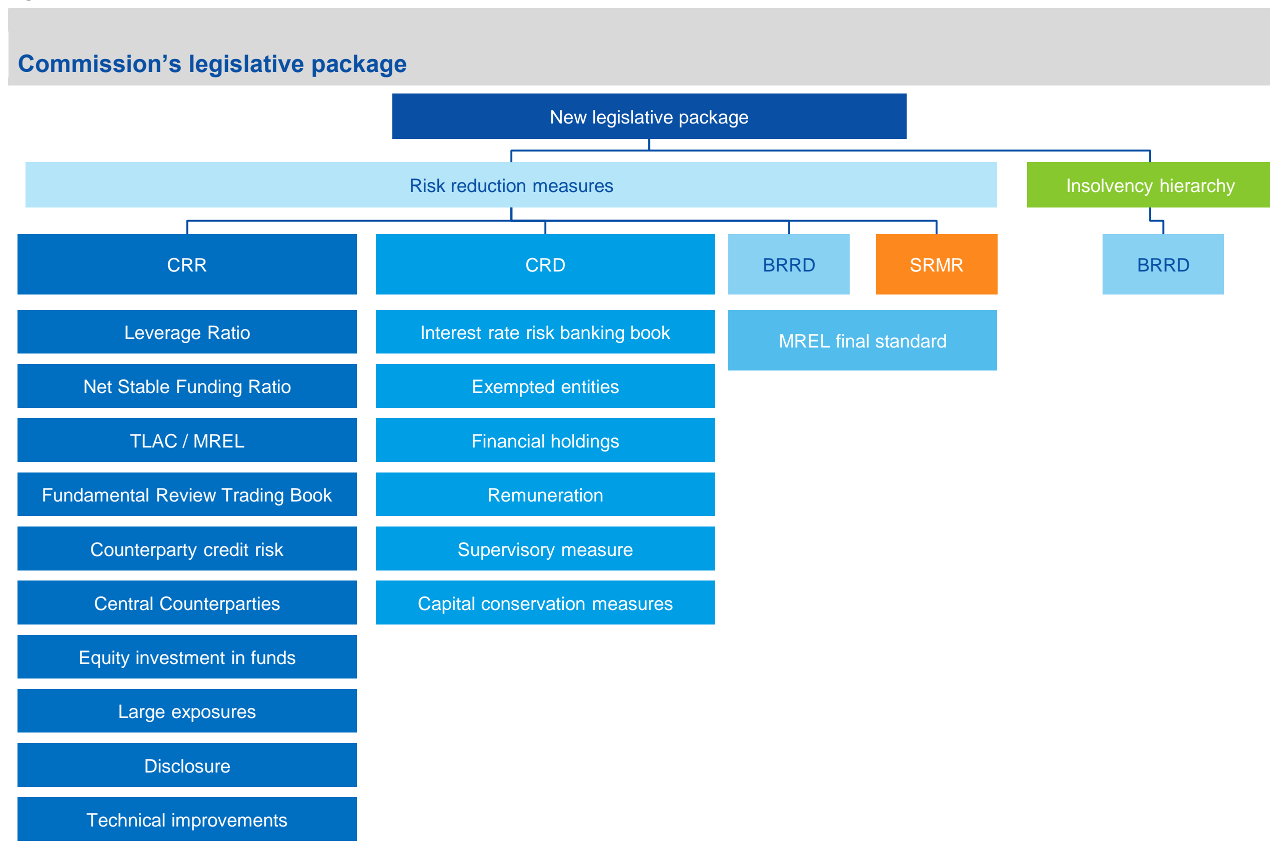
- Implementation of a new framework for measuring the **interest rate risk in the baking book**, which remains as a Pillar 2 risk.
- Update of the criteria and powers of the Commission to **exempt entities** from the compliance of the CRR and the CRD IV.
- Inclusion of **financial and mixed financial holdings** under the scope of CRD IV. A provision is introduced so that third country banking groups, which are G-SIBs or have total assets above EUR 30 billion and two or more subsidiaries operating in the EU, have to establish an intermediate parent undertaking in the EU.
- **Remuneration rules** have been adapted to ensure their proportional application. Small and non-complex institutions will not be subject to deferral rules and pay-out requirement in their variable remuneration.
- **Pillar 2 framework** is clarified, differentiating between Pillar 2 requirement and guidance. Also light is shed regarding the stacking order for the activation of **capital conservation measure**.

2. **Resolution framework**: the Bank Recovery and Resolution Directive is also modified to include:
   - Clarification of the MREL requirement and a harmonised ranking of unsecured debt instruments in **insolvency hierarchy**.

The Commission's proposal is only the first step in the European legislative process. Negotiations will now begin in the Parliament and the Council, both of which need to reach an internal agreement before trilogues can begin and a final text is agreed. The negotiation process is expected to last approximately one year, and after the approval of the final text, the different measures will have a specific date for their entry into force.

Figure 1

Commission's legislative package



Source: BBVA Research

BBVA Research assessment

- **The Commission's proposals present a wide and comprehensive review**. The implementation of international standards is positive and technical improvements are welcomed. After three years of application of the current prudential framework, we are in a good position to identify issues that are not working as expected.
- **Adjustments made to reflect European specificities are welcome**. Nevertheless, it is also necessary to take into account the specificities of the markets in which European banking groups operate in order not to unduly penalise banking groups with a global footprint.
- **Clarification of the new Pillar 2 framework is very positive**, as legal certainty was needed. Nevertheless, the breach of the MREL requirement should not trigger the activation of the Maximum Distributable Amount (MDA), as this requirement has a different nature than the prudential requirements.
- **This legislative proposal already includes some of the standards that have been discussed under the review of the Basel III framework**, namely: i) the new framework for interest rate risk in the banking book, ii) the revised standardised approach for counterparty credit risk and iii) the fundamental review of the trading book. The rest of the elements of the so-called Basel IV remain under discussion by the group of governors and heads of supervision (GHOS) and will be implemented into the European framework once an international agreement has been reached.

Annex 1: principal monitoring indicators for the Spanish banking system

Table 1

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

									Growth rate		
Assets	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**Date**	**00-'08**	**08 - latest**	**y-on-y**
Total lending	2,153	2,106	1,951	1,716	1,651	1,603	1,539	Oct-16	217%	-29.3%	-4.3%
Public corporations	*79*	*90*	*114*	*87*	*101*	*90*	*92*	*Oct-16*	*69%*	*73.5%*	*-2.8%*
Domestic resident sector	*1,844*	*1,783*	*1,605*	*1,448*	*1,380*	*1,327*	*1,270*	*Oct-16*	*234%*	*-32.1%*	*-4.8%*
Non residents	*230*	*234*	*232*	*180*	*169*	*186*	*177*	*Oct-16*	*164%*	*-30.2%*	*-1.4%*
Fixed income securities and equity stakes	564	656	766	773	754	662	629	Oct-16	132%	26.4%	-8.6%
Fixed income securities	*384*	*406*	*509*	*493*	*492*	*415*	*382*	*Oct-16*	*135%*	*17.1%*	*-13.6%*
Of which: sovereign debt	*165*	*198*	*247*	*264*	*288*	*251*	*238*	*Oct-16*	*6%*	*138%*	*-7.8%*
Equity	*180*	*251*	*258*	*280*	*262*	*246*	*247*	*Oct-16*	*128%*	*43.8%*	*0.4%*
Interbank lending	234	251	279	211	155	164	156	Oct-16	81%	-40.7%	-2.3%
Other assets (net of interbank lending/deposits)	301	387	426	326	354	331	339	Oct-16	230%	18.3%	-1.1%
Total assets	**3,252**	**3,400**	**3,423**	**3,026**	**2,913**	**2,760**	**2,663**	**Oct-16**	**184%**	**-17.4%**	**-4.9%**
Liabilities and Shareholders' Equity											
Customer deposits	2,031	1,934	1,725	1,684	1,686	1,637	1,576	Oct-16	169%	-21.7%	-5.0%
Public corporations	*79*	*70*	*69*	*63*	*76*	*77*	*62*	*Oct-16*	*263%*	*-19.0%*	*-29.8%*
Domestic resident sector	*1,440*	*1,373*	*1,317*	*1,314*	*1,289*	*1,261*	*1,233*	*Oct-16*	*192%*	*-14.0%*	*-1.6%*
Non residents	*511*	*492*	*339*	*306*	*320*	*299*	*281*	*Oct-16*	*113%*	*-44.3%*	*-11.2%*
Interbank deposits	270	373	573	381	312	303	293	Oct-16	95%	-6.9%	-5.0%
Pro memoria: net interbank position	*36*	*122*	*294*	*171*	*157*	*139*	*137*	*Oct-16*	*215%*	*164%*	*-7.9%*
Debt issued	433	435	394	297	249	225	200	Oct-16	625%	-49.3%	-9.0%
Other liabilities	340	439	535	430	436	368	365	Oct-16	253%	14.3%	-5.1%
Shareholders' equity	178	220	195	233	230	227	229	Oct-16	134%	26.9%	0.5%
Pro memoria: ECB funding	*70*	*132*	*357*	*207*	*142*	*133*	*136*	*Nov-16*	*566%*	*47%*	*0.1%*
Total Liabilities and Shareholders' Equity	**3,252**	**3,400**	**3,423**	**3,026**	**2,913**	**2,760**	**2,663**	**Oct-16**	**184%**	**-17.4%**	**-4.9%**

Source: Bank of Spain statistics bulletin

Table 2

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

	2010	2011	2012	2013	2014	2015	2016	Date	Growth rate 00-'08	08-latest	y-on-y
Net interest revenue	34,292	29,565	32,739	26,816	27,118	26,411	18,187	Sep-16	92%	-31.0%	-9.3%
Net fees and commissions	11,870	11,750	11,275	10,931	11,257	11,237	8,198	Sep-16	79%	-16.1%	-2.8%
Trading gains and other revenue	17,151	15,811	15,493	17,797	17,043	13,884	10,265	Sep-16	276%	-24.8%	-7.2%
Total revenue	**63,313**	**57,126**	**59,507**	**55,544**	**55,418**	**51,532**	**36,650**	**Sep-16**	**118%**	**-26.4%**	**-7.3%**
Operating expenses	-29,431	-28,464	-26,951	-26,798	-26,116	-26,261	-19,670	Sep-16	54%	-11.1%	0.7%
Personnel expenses	-17,643	-16,889	-15,587	-15,108	-14,329	-14,182	-10,430	Sep-16	54%	-22.3%	-1.8%
Other operating expenses	-11,789	-11,574	-11,364	-11,690	-11,787	-12,079	-9,240	Sep-16	54%	6.1%	3.6%
Pre-provision profit	**33,882**	**28,662**	**32,556**	**28,746**	**29,302**	**25,271**	**16,980**	**Sep-16**	**226%**	**-38.6%**	**-15.1%**
Loan-loss provisions	-16,719	-22,668	-82,547	-21,800	-14,500	-10,698	-5,259	Sep-16	620%	-54.0%	-34.9%
Other income, net	-7,326	-23,430	-37,142	-2,789	-1,739	-3,819	-2,546	Sep-16	-299%	173.6%	-4.8%
Profit before taxes	9,837	-17,436	-87,133	4,156	13,063	10,754	9,175	Sep-16	108%	-40.0%	-0.8%
Net attributable income	**9,673**	**-14,717**	**-73,706**	**8,790**	**11,343**	**9,312**	**8,288**	**Sep-16**	**122%**	**-40.0%**	**15.9%**

Source: Bank of Spain statistics bulletin

Table 3

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

	2010	2011	2012	2013	2014	2015	2016	Date	Growth rate 00-'08	08-latest	y-on-y
Lending to the private sector / GDP	171%	166%	152%	139%	133%	123%	116%	Oct-16	94%	-30.8%	-9.4%
Private sector deposits / GDP	114%	111%	111%	113%	111%	107%	105%	Oct-16	69%	-0.9%	-4.8%
Number of employees	263,715	248,093	236,504	217,878	208,291	202,959	n.d.	Dec-15	14%	-27.1%	-2.6%
Number of branches	43,267	40,202	38,237	33,786	32,073	31,155	29,645	Sep-16	17%	-35.8%	-5.7%

Source: Bank of Spain statistics bulletin

Table 4

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

									Growth rate		
Lending volume	2010	2011	2012	2013	2014	2015	2016	Date	00-'08	08 - latest	y-on-y
Loans to households	**813**	**793**	**756**	**715**	**690**	**663**	**655**	**Sep-16**	**236%**	**-20.1%**	**-1.8%**
Of which:											
Housing loans	632	627	605	581	558	531	521	Sep-16	270%	-16.8%	-2.8%
Other loans to households	180	167	151	134	132	132	134	Sep-16	159%	-30.6%	2.3%
Lending to corporates and SMEs	**1,013**	**971**	**830**	**719**	**674**	**644**	**604**	**Sep-16**	**237%**	**-40.6%**	**-7.7%**
Of which:											
Lending to real estate	430	397	300	237	200	179	164	Sep-16	517%	-65.0%	-9.3%
Other lending to corporates and SMEs	583	574	530	482	474	465	440	Sep-16	142%	-19.6%	-7.1%
Total lending to domestic private sector *	**1,844**	**1,783**	**1,605**	**1,448**	**1,380**	**1,327**	**1,270**	**Oct-16**	**234%**	**-32.1%**	**-4.8%**
NPLs											
Loans to households	**26.0**	**28.7**	**37.0**	**49.4**	**46.8**	**37.0**	**34.7**	**Sep-16**	**1062%**	**42.6%**	**-11.3%**
Of which:											
Housing loans	15.2	18.2	24.0	34.6	32.6	25.5	24.0	Sep-16	1878%	62.0%	-11.0%
Other loans to households	10.8	10.5	13.0	14.8	14.1	11.4	10.7	Sep-16	607%	12.3%	-11.9%
Lending to corporates and SMEs	**79.7**	**109.9**	**128.4**	**146.1**	**124.6**	**94.2**	**81.7**	**Sep-16**	**818%**	**119%**	**-19.2%**
Of which:											
Lending to real estate	58.0	81.9	84.8	87.8	70.7	50.4	43.5	Sep-16	2790%	62%	-20.7%
Other lending to corporates and SMEs	21.7	28.0	43.6	58.2	53.9	43.7	38.2	Sep-16	232%	267%	-17.4%
Total lending to domestic private sector *	**107.2**	**139.8**	**167.5**	**197.2**	**172.6**	**134.3**	**117.8**	**Oct-16**	**808%**	**87%**	**-16.3%**
NPL ratio											
Loans to households	**3.2%**	**3.6%**	**4.9%**	**6.9%**	**6.8%**	**5.6%**	**5.3%**	**Sep-16**	**246%**	**78.4%**	**-9.6%**
Of which:											
Housing loans	2.4%	2.9%	4.0%	6.0%	5.9%	4.8%	4.6%	Sep-16	434%	94.8%	-8.4%
Other loans to households	6.0%	6.3%	8.6%	11.1%	10.7%	8.7%	8.0%	Sep-16	173%	61.8%	-13.9%
Lending to corporates and SMEs	**7.9%**	**11.3%**	**15.5%**	**20.3%**	**18.5%**	**14.6%**	**13.5%**	**Sep-16**	**173%**	**269%**	**-12.4%**
Of which:											
Lending to real estate	13.5%	20.6%	28.2%	37.1%	35.3%	28.2%	26.5%	Sep-16	369%	363%	-12.5%
Other lending to corporates and SMEs	3.7%	4.9%	8.2%	12.1%	11.4%	9.4%	8.7%	Sep-16	37%	356%	-11.0%
Total lending to domestic private sector *	**5.8%**	**7.8%**	**10.4%**	**13.6%**	**12.5%**	**10.1%**	**9.3%**	**Oct-16**	**172%**	**175%**	**-12.0%**

(*)Total ORS loans include household loans, total loans for productive activities, non-profit agencies serving households (ISFLSH in Spanish) and unclassified lending. Since January 2014 this includes 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.)

Lending volume	2010	2011	2012	2013	2014	2015	2016	Date	Growth rate 03-'08	08-'15	y-on-y
Loans to households	**123.4**	**74.3**	**63.3**	**51.2**	**60.5**	**75.7**	**66.2**	**Oct-16**	**0.7%**	**-59.3%**	**7.8%**
Of which:											
Housing loans	69.5	37.5	32.3	21.9	26.8	35.7	31.1	Oct-16	-15.6%	-59.0%	7.8%
Other loans to households	53.9	36.8	31.0	29.4	33.7	40.0	35.1	Oct-16	21.3%	-59.5%	7.9%
Lending to corporates and SMEs	**665.0**	**527.5**	**484.8**	**392.6**	**357.2**	**392.6**	**265.6**	**Oct-16**	**29.2%**	**-57.7%**	**-18.0%**
Of which:											
Less than €250,000	164.3	136.4	114.4	106.1	112.3	128.7	109.9	Oct-16	n.d.	-21.7%	4.2%
Between €250,000 and €1million)	46.0	37.7	31.6	28.3	34.0	36.8	29.6	Oct-16	n.d.	-20.1%	-1.9%
Corporates (loans > €1mill.)	454.7	353.4	338.9	258.2	210.3	227.2	125.0	Oct-16	43.5%	-60.3%	-33.5%
Total new lending flows	**788.4**	**601.8**	**548.1**	**443.9**	**417.7**	**468.3**	**331.8**	**Oct-16**	**23.3%**	**-58.0%**	**-13.8%**

Source: Bank of Spain

Table 6

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

	2010	2011	2012	2013	2014	2015	2016	Date	Growth rate 00-'08	08 - latest	y-on-y
Sight deposits	262	270	265	282	329	384	439	Oct-16	100%	79%	18.0%
Savings deposits	211	203	199	206	222	254	274	Oct-16	73%	52.5%	11.8%
Term deposits	744	698	684	668	588	499	417	Oct-16	270%	-42.8%	-18.8%
Foreign currency deposits	19	18	20	21	22	21	21	Oct-16	527%	-28.7%	3.1%
Total deposits of domestic resident sector *	**1,236**	**1,188**	**1,168**	**1,177**	**1,160**	**1,159**	**1,151**	**Oct-16**	**163%**	**-2.7%**	**0.0%**

(*)Total ORS deposits do not match up with the data in Table 1 because the latter includes Asset transfer liabilities, Subordinated deposits, Repos and Hybrid instruments.
Source: Bank of Spain statistics bulletin

Table 7

Interest rates on loans (rates in % and variation in bps)

	2010	2011	2012	2013	2014	2015	2016	Date	Growth rate (bps) 03-'08	08 - latest	y-on-y
Loans. Stock (NDER)											
Loans to households											
Housing loans	2.74	3.12	2.61	2.11	1.89	1.53	1.32	Oct-16	178	-433	-25
Other loans to households	5.36	5.73	5.78	5.80	6.10	5.98	6.13	Oct-16	113	-94	14
Loans to corporates and SMEs	3.31	3.90	3.47	3.44	2.84	2.38	2.10	Oct-16	204	-345	-37
Loans. New lending transactions (APRC)											
Loans to households											
Housing loans	2.66	3.66	2.93	3.16	2.64	2.31	2.31	Oct-16	238	-353	-19
Consumer loans	7.47	9.11	8.32	9.52	8.98	8.43	8.57	Oct-16	237	-242	-48
Other	5.64	6.29	6.23	5.92	4.91	4.28	4.59	Oct-16	224	-244	-39
Loans to corporates and SMEs (synthetic average)	3.24	4.03	3.66	3.57	2.73	2.58	2.61	Oct-16	112	-226	-16
Less than €250,000	4.55	5.57	5.67	5.54	4.56	3.61	3.59	Oct-16	n.a.	-96	-44
Between €250,000 and €1million)	3.89	4.79	4.27	4.03	2.91	2.20	1.96	Oct-16	n.a.	-193	-44
Corporates (loans > €1mill.)	2.71	3.53	3.00	2.83	2.10	2.07	1.63	Oct-16	n.a.	-108	-24

APR: Annual Percentage Rate; NDER: Narrowly Defined Effective Rate (APR excluding commissions)
Source: Bank of Spain statistic bulletin

Table 8

Interest rates on deposits (rates in % and variation in bps)

	2010	2011	2012	2013	2014	2015	2016	Date	Growth rate (bps) 03-'08	08 - latest	y-on-y
Deposits. Stock (NDER)											
Households deposits											
Sight deposits	0.27	0.28	0.21	0.22	0.17	0.12	0.07	Oct-16	6.5	-62	-7
Term deposits	2.54	2.76	2.72	2.08	1.39	0.75	0.37	Oct-16	232	-404	-48
Corporates and SMEs deposits											
Sight deposits	0.68	0.61	0.37	0.35	0.31	0.24	0.15	Oct-16	111	-162	-4
Term deposits	2.56	2.68	2.64	1.93	1.40	0.91	0.66	Oct-16	223	-372	-30
Deposits. New transactions (NDER)											
Households deposits											
Sight deposits	0.27	0.28	0.21	0.22	0.17	0.12	0.07	Oct-16	30	-62	-7
Term deposits	2.74	2.79	2.83	1.50	0.66	0.39	0.13	Oct-16	225	-405	-29
Corporates and SMEs deposits											
Sight deposits	0.68	0.61	0.37	0.35	0.31	0.24	0.15	Oct-16	111	-162	-4
Term deposits	1.98	2.13	2.08	1.31	0.51	0.31	0.14	Oct-16	146	-333	-17

NDER: Narrowly Defined Effective Rate (APR excluding commissions)
Source: Bank of Spain statistics bulletin

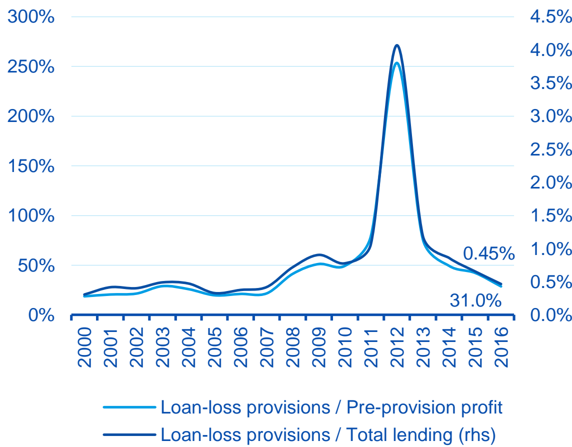
Table 9

Key ratios

	2010	2011	2012	2013	2014	2015	2016	Date	Growth rate 00-'08	08-latest	y-on-y
Productivity											
Business volume* per branch (€'000)	71,187	73,894	72,524	77,713	79,197	79,794	81,683	Sep-16	170%	23.5%	3.2%
Profit before tax per branch (€'000)	227.3	-433.7	-2,278.8	123.0	407.3	345.2	412.7	Sep-16	77.5%	-6.6%	5.2%
Efficiency											
Cost-to-Income ratio (Oper. expenses / Total revenue)	46.5%	49.8%	45.3%	48.2%	47.1%	51.0%	53.7%	Sep-16	-29.3%	20.7%	8.6%
Operating expenses / ATA	0.91%	0.86%	0.79%	0.83%	0.88%	0.93%	0.97%	Sep-16	-43.4%	1.1%	8.1%
Profitability											
RoE	5.2%	-7.4%	-35.5%	4.1%	4.9%	4.1%	4.8%	Sep-16	-3.4%	-53.3%	16.4%
RoA	0.30%	-0.52%	-2.55%	0.13%	0.44%	0.38%	0.45%	Sep-16	-23.6%	-31.7%	6.5%
NIM (Net interest rev. / ATA)	1.06%	0.89%	0.96%	0.83%	0.91%	0.93%	0.89%	Sep-16	-29.6%	-21.5%	-2.5%
Liquidity											
Loans-to-Deposits (resident sector)	149%	150%	137%	123%	119%	115%	110%	Oct-16	14.8%	-30.2%	-4.8%
Funding gap (Loans - Deposits, EUR bn)	607.9	594.4	436.8	270.9	220.1	168.3	119.4	Oct-16	349%	-82.6%	-35.0%
Funding gap / Total assets	18.7%	17.5%	12.8%	9.0%	7.6%	6.1%	4.5%	Oct-16	57.7%	-78.9%	-31.7%
Solvency and Asset Quality											
Leverage (Shareholders' equity / Total assets)	5.5%	6.5%	5.7%	7.7%	7.9%	8.2%	8.6%	Oct-16	-17.8%	53.6%	5.6%
Shareholders' equity / NPLs	166%	158%	117%	118%	133%	169%	195%	Oct-16	-74.3%	-32.1%	20.0%
Provisioning effort (Loan-loss prov. / Pre-provision profit)	49.3%	79.1%	253.6%	75.8%	49.5%	42.3%	31.0%	Sep-16	121%	-25.1%	-23.3%
Cost of Risk (Loan-loss provisions / total lending)	0.78%	1.06%	4.07%	1.19%	0.86%	0.66%	0.45%	Sep-16	134%	-38.0%	-30.3%
NPL ratio (resident sector)	5.8%	7.8%	10.4%	13.6%	12.5%	10.1%	9.3%	Oct-16	172%	175%	-12.0%
NPL coverage ratio (total)	66.9%	59.6%	73.8%	58.0%	58.1%	58.9%	60.7%	Oct-16	-58.2%	-14.3%	0.6%
NPL coverage ratio (specific provisions)	39.6%	37.1%	44.7%	46.9%	46.7%	47.0%	46.1%	Sep-16	-39.0%	54.1%	-3.8%

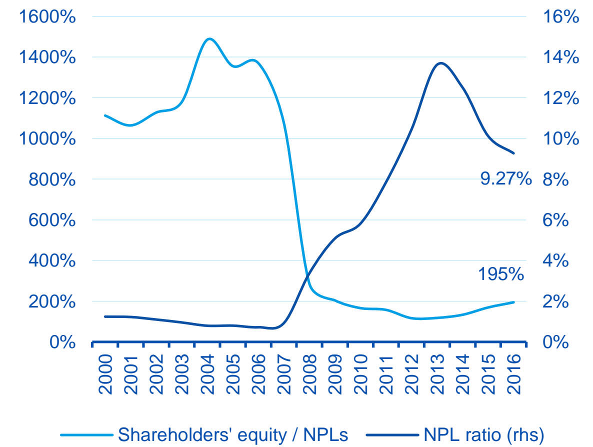
(*) ORS loans plus ORS deposits
Source: Bank of Spain statistics bulletin

Figure A1.1
Provisions



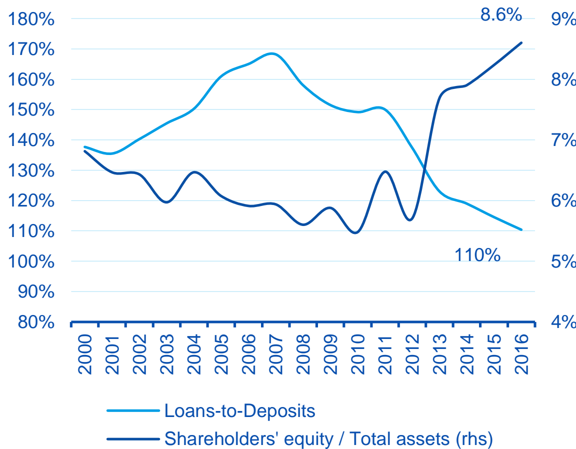
Source: BBVA Research

Figure A1.2
NPLs and Capital to NPLs



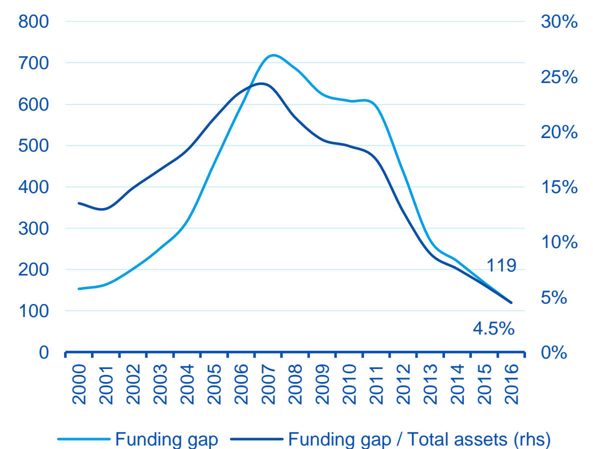
Source: BBVA Research

Figure A1.3
Liquidity and leverage



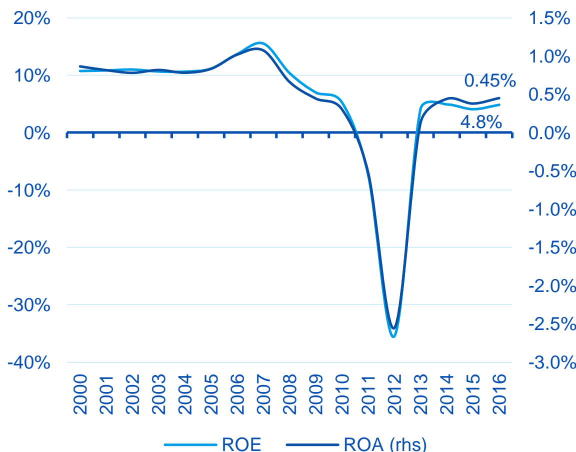
Source: BBVA Research

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



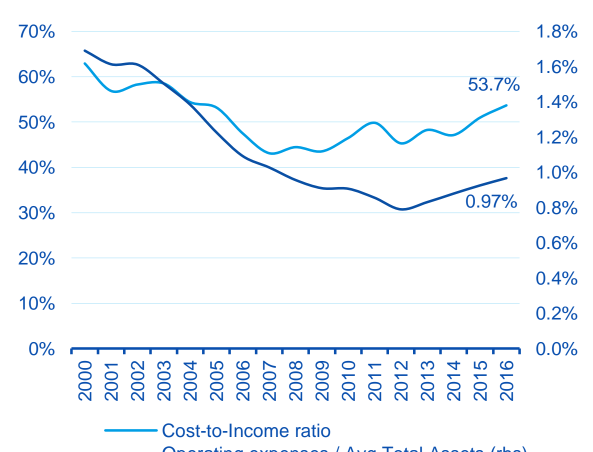
Source: BBVA Research

Figure A1.5
Profitability



Source: BBVA Research

Figure A1.6
Efficiency

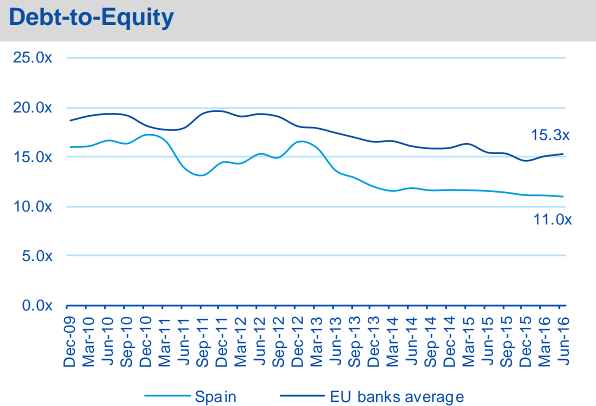


Source: BBVA Research

Annex 2: comparative analysis of the Spanish banking sector

Figure A2.1

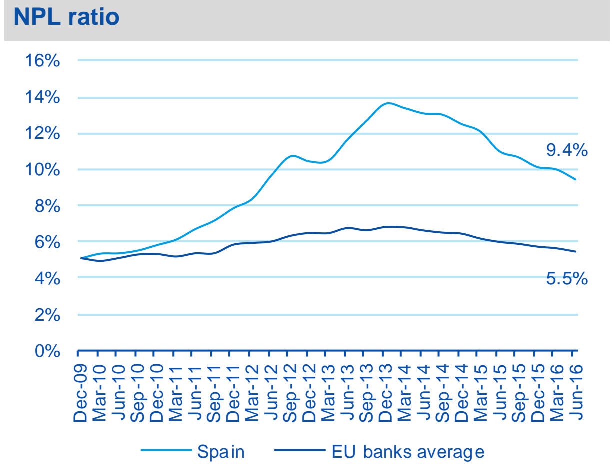
Debt-to-Equity



Source: EBA, BBVA Research

Figure A2.2

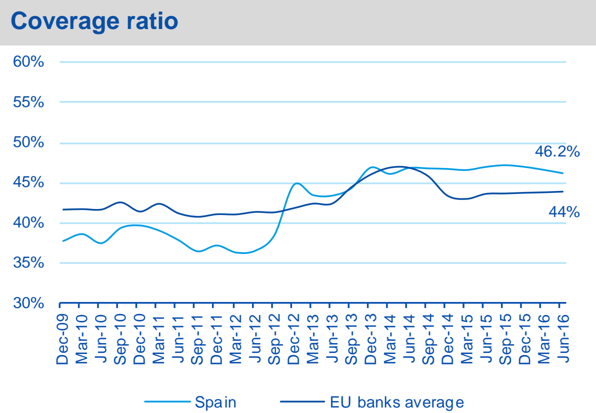
NPL ratio



Source: EBA, BBVA Research

Figure A2.3

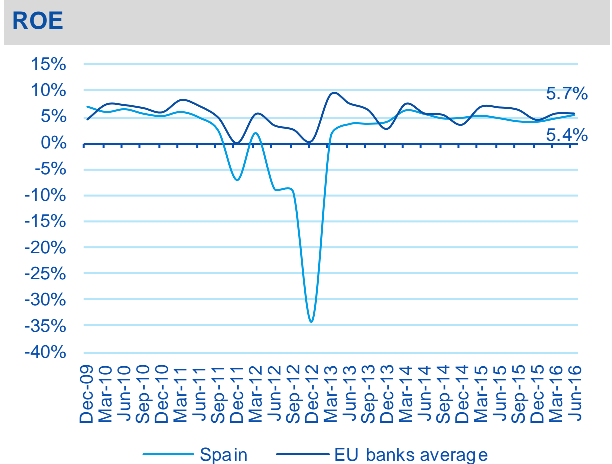
Coverage ratio



Source: EBA, BBVA Research

Figure A2.4

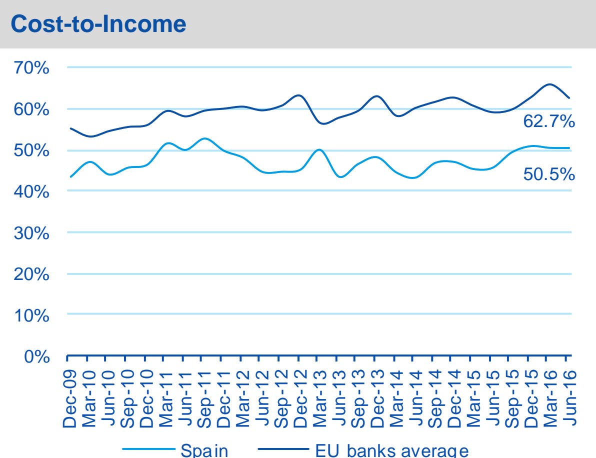
ROE



Source: EBA, BBVA Research

Figure A2.5

Cost-to-Income



Source: EBA, BBVA Research

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