BBVA Research

Banking Outlook

May 2019

Creating Opportunities

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Closing date: **May 29, 2019**

Summary

1. Developments in the Spanish banking sector

The net profit of the system in 2018 was €12.4 billion, the highest since 2009. The key factors affecting the sector's results were cost control and lower provisions. The deleveraging of the economy's private sector continues (although we expect the total volume of credit in the system to stabilise this year, 2019, and start growing slightly) and the level of NPLs in the system maintains its downward trend. Efficiency and profitability improved compared to 2017 levels.

2. Bank lending survey: the demand for credit continues to decelerate in the eurozone

The results of the April bank lending survey in the eurozone are similar to those in the previous quarters. The demand for corporate credit perceived by the banks has been slowing down to the point that it was unchanged in the first quarter of 2019. Consumer lending performed in the same way. In addition, lending criteria and conditions are no longer being relaxed. On the contrary, they are unchanged for companies and slightly tightened for households.

3. The cost of equity in European banking: on a downward trend since 2008 despite a higher bank-specific risk

We conducted a comparison of the recent performance of the average cost of equity in the banking systems of Spain, Germany, France and Italy. Using the CAPM methodology, the average cost of equity in all countries is currently lower than that calculated in 2008 (7.4% on average for the whole sample of banks analysed, versus 10.5% in 2008). The main factor explaining the decline is the performance of the risk-free rate (10-year German bond) since the beta (risk) of the banks is higher in almost every case and the markets' equity risk premiums have been stable for several years.

4. The new regulation on NPL coverage combines three frameworks: accounting, prudential and supervisory

Under the new regulation, NPL coverage will be driven by three complementary frameworks: (i) accounting framework (IFRS 9 since January 2018 applied a model-based forward-looking framework that could raise differences among banks and countries); (ii) supervisory (Pillar 2 applicable on a case by case basis as part of the SREP); and (iii) prudential, constructed as a Pillar 1 tool that will act as a backstop to the accounting rules, deducting from CET1 the difference between the accounting provisions and the newly applicable "prudential provisions".

5. SREP capital requirements in the eurozone rise due to the activation of counter-cyclical buffers

The prudential capital requirements (SREP) in terms of fully loaded CET1 in a sample of 48 banks in the eurozone recently reported by the ECB are 10% on average, ranging from 8% to 14.1%. More than half of the banks saw an increase in their requirements compared to the previous year, mainly due to the activation of counter-cyclical buffers in a number of European economies. In the Spanish banks, the average SREP requirement is 9%.

1. Developments in the Spanish banking sector[1]

Jaime Zurita

Industry results

- The trend seen in previous quarters was confirmed when taking the year 2018 as a whole: cost control and lower provisions were the key factors in the results of the sector (Table A1.2).

- However, at year end, total revenue is showing a slight recovery compared to that achieved in 2017. Net interest revenue is practically unchanged from the previous year (+0.2%) despite the volume of lending continues to decline, the reduction in NPLs is slowing down in the fourth quarter of the year and interest rates show no signs of rising.

- As can be seen in Table A1.7, the rates applied to new loans have risen for household lending and fallen further in company lending, although the prices of new loans are higher than the average rates of the stock in all portfolios (spreads on new operations are higher). Interest rates on deposits (Table A1.8) continue to narrow, but there is now virtually no room for this trend to continue.

- Net fees and commissions maintained the path seen in previous quarters and grew by 3.5% over the course of the year, slightly higher than the cumulative growth to September. In this regard, trading gains and other operating revenue also grew in 2018, although their growth was slower than in previous quarters. As a result, total revenue in 2018 increased by 2.2%.

- As we have discussed, cost control continues to be one of the drivers of the results of the system in 2018. Total operating expenses declined by 2.5% over the course of the year, in line with the trend seen in previous quarters, with falls in all items. Personnel expenses fell by 2.1% and general expenses by 3.1%. Due to the performance of total revenue and expenses, the cost-to-Income ratio improved by almost 3 percentage points in 2018 to 54.4% and pre-provision income grew by 8.5%.

- In the lower part of the income statement we can see a significant improvement compared to the net result in 2017, a year in which the resolution and sale of Banco Popular had a negative impact of more than €10.3 billion on the results of the sector. As a consequence, in 2018 the loan-loss provisions and the net result of the deterioration in other items on the balance sheet and other extraordinary results improved by 66% and 63%, respectively. In any case, one aspect to highlight is that both the cost of risk (loan-loss provisions / average total lending) and effort in provisions (loan-loss provisions / pre-provision income) were 0.20% and 14.3% respectively in 2018, in line with levels seen before the recent financial crisis and, therefore, substantially lower than the levels seen in the last few years.

- In short, the net attributable income of the system in 2018 was €12.4 billion, the highest since 2009, compared to a loss of €3.9 billion in 2017.

1: Tables and data can be found in the appendices to this document. The data used for the analysis of the Spanish banking system is in chapter 4 of the Statistical Bulletin of the Bank of Spain and the data used for international comparison is in the Risk Dashboard of the European Banking Authority (EBA). Analysis of the Spanish banking industry **is confined to banking business in Spain**. In all documents, "€ bn" are billions of euros.

Activity

- The system has continued to shrink again this quarter (Table A1.1). Based on data as of February 2019, the total volume of the sector's balance sheet contracted by 1.5% year-on-year to stand at a volume of €2.56bn, a size similar to that seen in December 2006, which represents 212% of GDP (324% in 2012). The contraction of the balance sheet has led to a parallel reduction in the number of branches and employees in the system, which have declined by 31% (as of December 2017, the latest information available) and 43% (December 2018) respectively, from the peaks seen in 2008.

- The main cause of this development has been the necessary deleveraging of the private sector in the Spanish economy. The ORS (Other Resident Sectors) lending volume fell by an additional 2.8% as of February 2019. Fixed-income and equity portfolios have also fallen in year-on-year terms. In the last twelve months, the only item to have grown is loans to non-residents.

- The liabilities side showed a slight increase in ORS deposits (+2.9%) and a stronger increase in deposits of the Public Administrations (+16.4%) over the last year to February, while deposits of non-residents fell by 6%. In greater detail, sight deposits (Table A1.6) continued their upward trend and increased by 10% year-on-year, while term deposits contracted an additional 16% to February this year. The appeal for liquidity from the ECB reduced marginally based on data as of March 2019, and the volume of debt on the balance sheet has remained virtually unchanged since February of last year. The volume of own funds on balance-sheet (paid-in capital and retained earnings) has fallen slightly in the last twelve months (-2.8%) due to the losses from the year 2017 and the initial impact of the entry into force of the international accounting standards IFRS 9.

Spotlight on lending and NPLs

- As mentioned, the volume of lending to the private sector (Table A1.4) fell by 2.8% year-on-year to February 2019, €1.19bn, representing 99% of GDP compared to 171% at the end of 2010 (Table A1.3). It seems reasonable to assume that this trend will continue for a few more months, since several banks have announced sales of loan portfolios and assets that will be completed during this year.

- By portfolio (based on data as of year-end 2018, Table A1.4) the fall in the stock of lending is due to a further reduction in lending to companies, since lending to households remained stable at the same volume as the year before. Lending for house purchases fell slightly in 2018, while lending to households for purposes other than house purchases grew by 4.5%. On the other hand, total lending to companies fell by 7.3% over the course of 2018, especially lending for real estate activities and construction which contracted by 18.8%, in part due to the sales of assets and loans conducted throughout the year.

- The quality of the system's assets continues to improve. The amount of non-performing loans in the system fell again in the first two months of 2019 and in year-on-year terms it contracted by 27.6%. The non-performing loan rate in February 2019 (5.82%) remained stable at the same level seen in December 2018, as a result of the contraction of lending, but has fallen by 199 bps since February 2018. From the peak of December 2013, the volume of non-performing loans in the system has fallen by 65% (-€128bn).

- With regard to new lending operations (Table A1.5), the cumulative volume of new production in the first quarter of 2019 is 4.9% lower than the cumulative figure to March 2018. However, new lending operations have had three consecutive years of growth and currently represent around 40% of the annual volume of the years immediately prior to the start of the crisis.

Key ratios

- Based on data as of year-end 2018 (Table A1.9), the system maintained levels of productivity that are all-time highs for the historical series. As a result, the efficiency indicators improved over the course of 2018 despite the weak performance of income. The cost-to-Income ratio stands at 54.4% and total operating expenses remain at just under 1% of the balance sheet (Figure A1.6). These levels are a benchmark in Europe.

- With regard to profitability (Figure A1.5), this has returned to positive territory after a year in the negative due to the resolution of Banco Popular. ROE and ROA stood at 5.4% and 0.55% respectively, and the NIM (net interest revenue / average total assets) continued in line with that seen in previous years. As discussed, the reduction in provisions (Figure A1. 1) is one of the factors behind the system's profitability, which in any case remains below pre-crisis levels, especially ROE, in part due to the capital accumulation caused by the recent crisis.

- The indicators for the system's solvency remain slack. The volume of capital on the balance sheet (paid-in capital and reserves) reached 8.7% of total assets as of February 2019 (Figure A1.3), a volume that is 3.2 times the system's NPL volume (Figure A1.2). From a regulatory perspective, the system's CET1 ratio stood at 12.2% at the close of 2018, 43 bps below the level in 2017 due, for the most part, to the effects of transitional adjustments.

- Liquidity continues not to be a problem in general terms, and we expect that this will remain the case after the recent announcement of a new TLTRO from the ECB, whose details will be announced in June. The funding gap (difference between ORS lending and ORS deposits, Figure A1.4) fell again in the first two months of 2019 to reach a new record low, 1.1% of the total balance sheet, a long way from the peak in 2007 (24% of the balance sheet), with a decrease of more than €685bn.

International comparison[2]

Once again this quarter, the main conclusions remain the same:

- Spanish banks have a better solvency quality, measured in terms of the total balance sheet, not RWA, and are more efficient than their European competitors (Figures A2.1 and A2.5).

- The system's NPL ratio continues to be higher (Figure A2.2) despite the decline in the volume of non-performing loans.

- Profitability returned to positive levels after the impact of the losses derived from the resolution of Banco Popular in 2017 (Figure A2.4).

- Regarding the stabilisation of the balance sheet, the impairment of the 2017 coverage ratio caused by increased recognition of NPLs with Banco Popular was a one-time event (Figure A2.3).

2: The comparison of the Spanish banking system with the average of EU banks (appendix 2) was carried out with data from the "Risk Dashboard" from the European Banking Authority (EBA), which contains the average of over 150 of the main banking entities in the EU at the consolidated level. The latest data available is from September 2018.

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2. Bank lending survey: the demand for lending continues to decelerate in the eurozone

Inés Salinas / Adrián Santos

The results of the April bank lending survey in the eurozone[3] show the same trend as seen in previous quarters. The demand for business lending perceived by the banks has been slowing down and remained unchanged in the first quarter of 2019, with consumer lending performing in the same way. Lending criteria and conditions applied to new loans were not relaxed in the quarter. They were unchanged for lending to companies and very slightly stricter for lending to households.

Demand for lending

The demand for lending has slowed down in recent quarters according to the responses from the banks in the eurozone. Companies have reduced their funding needs gradually to the extent that in the first quarter of 2019 demand has remained flat compared to the previous quarters. German companies are the only ones among the major euro economies to be increasing their demand for bank lending, although increasingly less intensive, while a reduction in demand has been seen in Italy and Spain. In this regard, the demand for mortgages from households has been increasing in recent quarters, although with some differences between countries (Italy, among the large ones, is the only one that remains unchanged). With regard to demand for consumer credit, this has significantly weakened over the last six months, remaining unchanged in the first quarter of 2019. A decline has been observed in France and, to a greater extent, in Spain. However, the banks expect an increase in the need for this type of lending in the second quarter of the year.

Table 1 Variation of demand for loans (In orange, increase; in blue, decrease)

							Households											
	NFCs						Mortgages						Consumer and other					
	2018				2019		2018				2019		2018				2019	
	1Q	2Q	3Q	4Q	1Q	2Q*	1Q	2Q	3Q	4Q	1Q	2Q*	1Q	2Q	3Q	4Q	1Q	2Q*
Eurozona	15	16	12	9	0	5	5	23	5	12	14	10	14	25	22	8	2	18
Alemania	9	25	10	22	16	9	14	21	3	10	14	17	9	38	6	10	6	13
Francia	0	-3	4	-15	0	17	-40	17	-22	12	20	-20	9	14	36	9	-7	21
Italia	30	10	30	20	-20	-10	10	20	10	10	0	20	40	30	20	0	0	20
España	0	0	-20	-20	-20	-10	22	22	22	-11	11	22	20	60	40	0	-20	10

Note: The table shows the variation in the demand perceived by the banks compared to the previous quarter. The values show the difference between the percentage of responses saying increase minus the percentage of responses saying decrease. *Q2 expected variation.
Source: BBVA Research based on data from the Bank of Spain

3: European Central Bank. Bank Lending Survey, April 2019.

Approval criteria

The approval criteria for loans have not changed for the banks in the eurozone. With regard to lending to companies, the variation in the criteria is minimal. The further tightening of the criteria has been in the mortgage sector, in which for several quarters countries such as Italy have been tightening the requirements for their granting, and this is expected to be the same in the second quarter of 2019. In contrast, the banks expect a relaxation in the criteria for the granting of consumer credit, particularly for France and Italy. In Spain, in both mortgage loans and consumer loans, there has been a tightening in the approval criteria in the last quarter.

Table 2 Variation in the criteria for the approval of loans (In orange, tightening; blue, relaxation)

	NFCs						Households											
							Mortgages						Consumer and other					
	2018				2019		2018				2019		2018				2019	
	1Q	2Q	3Q	4Q	1Q	2Q*	1Q	2Q	3Q	4Q	1Q	2Q*	1Q	2Q	3Q	4Q	1Q	2Q*
Eurozona	-8	-3	-6	-1	-1	-2	-11	-8	-2	-1	3	4	-3	-3	1	2	2	-9
Alemania	-3	-3	-3	-3	3	0	-7	-7	-3	0	7	0	-9	-3	3	0	0	0
Francia	-18	0	0	0	-4	0	-14	-2	-2	-2	-2	12	-2	0	0	0	0	-22
Italia	-20	-10	-10	10	0	0	-10	0	0	10	10	10	0	0	0	0	0	-10
España	0	-10	-10	0	0	-10	-11	-11	0	0	11	0	-10	-20	-10	10	10	0

Note: The table represents the variation in criteria perceived by the banks compared to the previous quarter. The values show the difference between the percentage of responses saying tightening minus the percentage of responses saying relaxation. *Q2 expected variation.
Source: BBVA Research based on data from the Bank of Spain

Conditions applied to the loans

In general terms, the conditions applied to the loans have not seen significant changes in comparison with the previous quarter. However, it is worth noting the tougher business credit and mortgage loan conditions in Italy, due mainly to an increase in the cost of finance and the higher perceived risk. Also remarkable is the significant relaxation in the terms and conditions of consumer loans in Spain, which is despite the slight tightening seen in Q4. Despite this, the trend towards the relaxation of conditions in the eurozone has been on the decline in recent quarters until now.

Table 3 Changes in terms and conditions on loans (In orange, tightening; blue, relaxation)

	NFCs					Households									
						Mortgages					Consumer and other				
	2018				2019	2018				2019	2018				2019
	1Q	2Q	3Q	4Q	1Q	1Q	2Q	3Q	4Q	1Q	1Q	2Q	3Q	4Q	1Q
Eurozona	-17	-16	-7	-3	1	-6	-9	-2	-4	-1	-4	-8	0	-4	2
Alemania	-19	-9	-10	-3	3	-10	-7	-7	-7	0	-6	-6	6	0	-3
Francia	-21	-13	0	0	3	0	-14	7	7	0	0	-7	0	-7	7
Italia	-10	-20	10	10	10	-10	-20	10	0	10	0	-10	0	0	0
España	-20	-30	-20	-10	0	-11	-11	0	-11	0	-30	-30	-20	-20	10

Note: The table represents the changes in conditions seen by banks in relation to the previous quarter. The values show the difference between the percentage of responses saying tightening minus the percentage of responses saying relaxation.
Source: BBVA Research based on data from the Bank of Spain

3. CoE in European banking: on a downward trend since 2008 despite a higher bank-specific risk

Jaime Zurita

We compared the evolution of the cost of equity (COE) in the banking systems in Spain, Italy, Germany and France. The analysis is limited to the banks listed in each system.

Methodology: CAPM

Firstly, it is important to define the COE accurately: It is not a cost but a minimum return. It is an estimate of the minimum return required by the potential investors in a firm's share capital as of this moment. COE is a very relevant matter for banking institutions: it is the price of taking risks (from the shareholder's perspective), the measure used to assess the bank's projects and the key, together with the ROE, used by the market to determine the value of the banks themselves.

The method used to calculate the cost of equity is the CAPM (Capital Asset Pricing Model), which establishes that the return required by the company's shareholders, E(Ri), is equal to the sum of the risk-free rate (Rf) plus an additional return that will compensate for the risk of investing in that specific asset (common shares), calculated as the product of the bank beta multiplied by the equity market risk premium (expected equity market returns, E(Rm), minus the risk-free rate). This is summed up in the well-known formula:

$$E(Ri) = Rf + \beta i[E(Rm) - Rf]$$

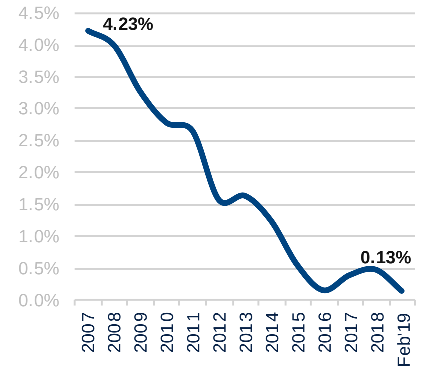
This calculation method has the advantage of using measurable data as provided by the market and, therefore, requires a minimum number of hypotheses. We analyse the components of the COE separately.

With regard to **the return of risk-free assets**, assets are believed to be risk-free if it is possible to calculate its return with certainty. This leads us to a zero-coupon sovereign bond issued in the currency in which revenues and expenses will be made, with a maturity similar to that of the projects analysed. In practice, however, it is accepted that the risk-free asset in the eurozone is the 10-year German bond, the profitability of which is set out in figure 1. **The fall seen in recent years in the risk-free rate is the most determining factor in the performance of the COE of European banks**.

Beta is a measure of the individual banks' risk, calculated as the slope of the linear regression (taking 2 years of daily data) of the daily variation in share prices with the daily variation in the index in which they are listed. We take the deepest and most liquid index in which the company's shares are listed as a benchmark for the regression. The average beta of each country is obtained by weighting the banks' simple average beta by each bank's total volume of assets. As shown in figure 2, **the average beta across all countries is above 1 throughout the period studied**, which implies that all banking systems are perceived as sectors with a level of risk that is above market average. On the other hand, in all cases except France, the average beta for 2019 is higher than that for 2007. As we have already seen, the beta collects the non-diversifiable risk of each company as it is perceived by the market. In this vein, it is not only affected by the fundamentals of the banks but also by the specific characteristics of the market itself and the volatility of the shares listed on that market, their liquidity, the existence of very large companies or the absence of companies with these conditions, etc.

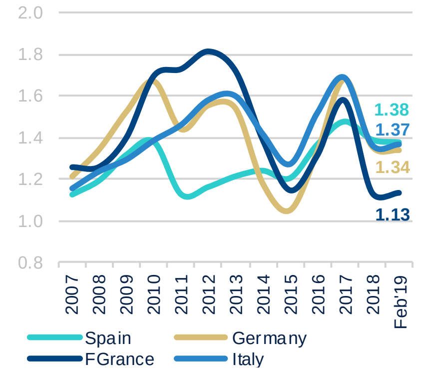
Lastly, **the equity market risk premium** is the minimum profitability above the risk-free rate required for investing in equity, as an asset class. It is a measure of equity market risk for each country, not for individual shares (which is reflected in the beta). With the exception of the US market, there is not enough historical financial data for the equity markets in the countries analysed to calculate the market risk premium using historical data. Therefore, we use an alternative method that consists of adding a "spread by country risk" to the risk premium calculated for the US market (the S&P500 Index). This "spread by country risk" is calculated by multiplying the equity market risk premium of the American market by the relationship between the standard deviation in the equity market of each country (since data has been available) and that of the American market. Graph 3 shows that the market risk premium **is similar across all countries and has remained reasonably stable for several years**.

Figure 1 Risk-free rate



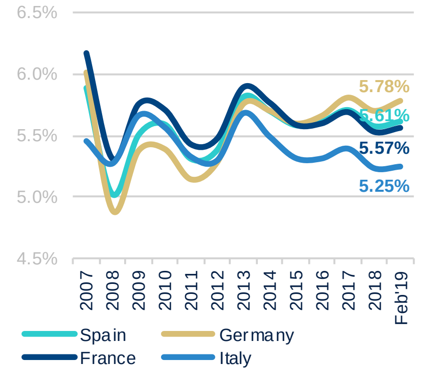
Source: Bloomberg

Figure 2 Average beta



Source: Bloomberg

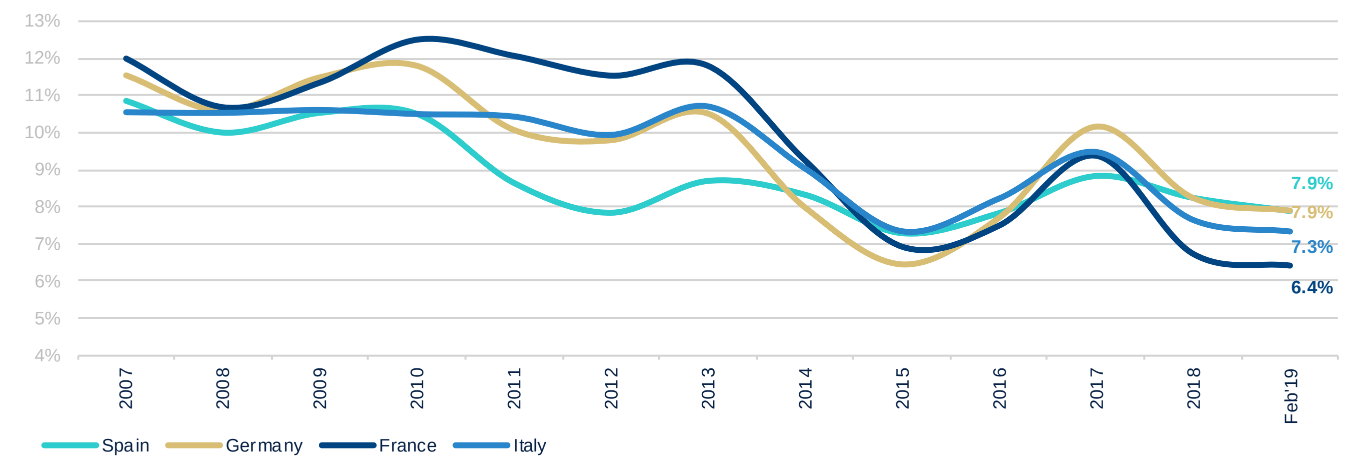
Figure 3 Market risk premium



Source: Bloomberg

We used the above data to obtain the average COE for the four banking systems, weighted by volume of assets of the banks that are publicly listed in each one (Figure 4). **In all cases, the COE in 2019 is lower than at the start of the crisis**, which is reasonable if we take into consideration that it is a minimum expected return. The current interest rate environment in the eurozone drastically reduces the opportunity for profitable investments, which is reflected in the COE of the banks. The main cause of this performance is the risk free rate, since the risk faced by banks (beta) is higher in almost every case and the equity market risk premium has been stable for several years.

Figure 4 Evolution of the cost of average capital



Source: Bloomberg

4. The new regulation on NPL coverage combines three frameworks: accounting, prudential and supervisory

María Rocamora

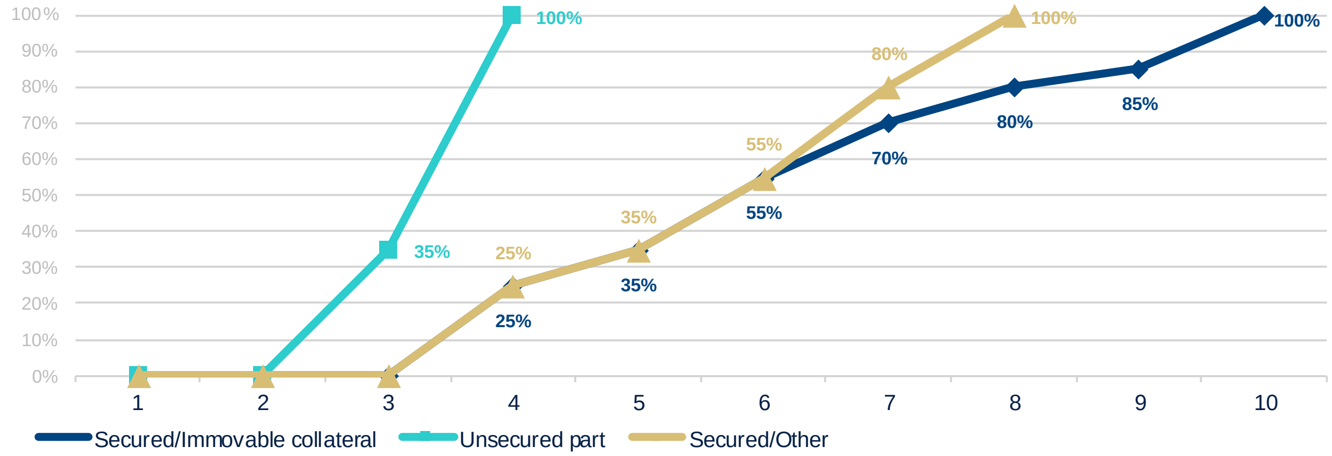
NPL prudential backstop: applicable since April 2019

The recent approval of the CRDIV package has introduced a prudential backstop for non-performing exposures. The backstop aims at complementing the current prudential provisioning rules with a deduction from own funds where NPEs are not sufficiently covered by provisions or other adjustments. The purpose of the new regulation is to increase banks' available buffers to withstand adverse economic shocks and avoid an eventual credit crunch in the event of a crisis. The new regulation covers all EU banks.

The new rules distinguish between unsecured and secured non-performing exposures. For secured loans, the regulation differentiates between immovable collateral such as property and "other eligible credit protection". Loans with collateral consisting of immovable property must be 100% covered by the tenth year, while loans with lower quality collateral must be fully covered after the seventh year. For the unsecured exposures, they must have a coverage of 35% by the end of the third year and full coverage by the fourth year.

The goals of the prudential backstop and those of IFRS 9 are complementary. The latter aims at tackling the issue "too little, too late", forcing banks to recognize provisions on a timely and forward-looking basis. Therefore, provisioning needs are assessed on performing exposures (Stage 1 and Stage 2 loans) and non-performing exposures (Stage 3). The former is part of the prudential regulation to safeguard financial stability in the long term.

Figure 1 Calendar of minimum prudential provisions, years since origination, percentage.



Source: Regulation (EU) 2019/630 and BBVA Research

Implications and impact assessment

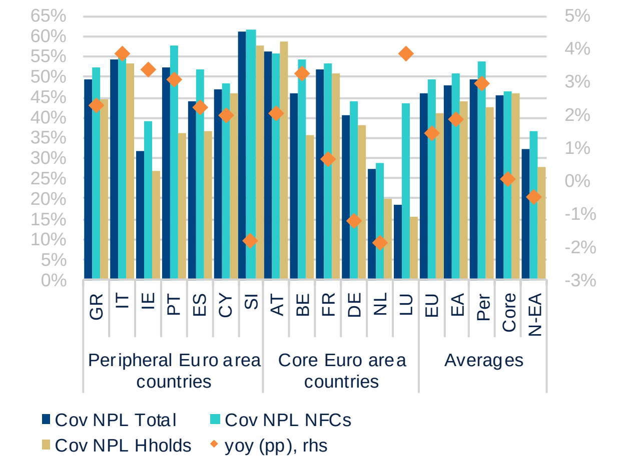
The approved regulation will apply to new loans granted since 26th April 2019 and not to the pre-existing stock, which will be driven by IFRS 9 accounting rules. In this sense, the effects of the new prudential framework will not be observed in the medium term, as all EU countries' NPL ratio has declined in the period 2017Q4-2018Q44 and the positive macroeconomic data indicate a low probability of an increase in NPLs from new loans.

From an operational perspective, banks may need to maintain two parallel provisioning frameworks unless they choose to apply the new framework to the existing stock. However, it is expected that both frameworks converge in the long term.

From a provisioning perspective, coverage ratios only depend on the accounting framework (IFRS 9). This principle-based framework leaves room for interpretation, which explains the divergence in coverage ratios across the EU. Data as of December 2018 show an average total coverage ratio for the EU of 45%[5]. Some countries (Ireland, Spain, Belgium, Germany, Netherlands, Finland, Luxembourg, Denmark, Norway, Sweden and United Kingdom) are below EU average and might need additional efforts to comply with the new EU regulation, although every case is unique. By group of countries, peripherals (50%) display the highest coverage ratios, followed by core (46%) and non-Euro area countries (32%). Therefore, peripherals would need less additional provisioning efforts[6].

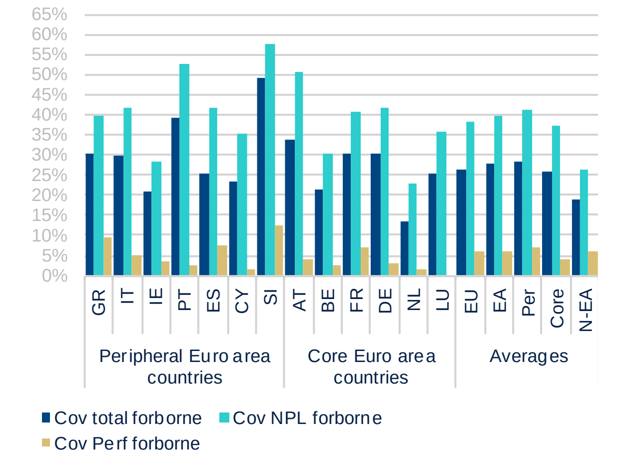
By portfolios, data as of June 20187 show that loans to non-financial corporations have higher coverage ratios (50% on average in the EU) than households (41%). Nevertheless, households portfolio display the highest proportion of lending secured by immovable property (highest quality collateral), which is subject to the least stringent calendar (full coverage is reached in the tenth year), resulting in a contained impact in the medium term.

Figure 2A Coverage ratio (total, NFCs and households), June 2018 and evolution in the period 2017Q2-2018Q2



Source: EBA and BBVA Research

Figure 2B Coverage ratio for forborne exposures (total, NPL and performing), June 2018



Source: EBA and BBVA Research

4: NPL ratio declined to a level of 3.2% (2018Q4), from 4.1% (2017Q4). Source: EBA Risk Dashboard.
5: Source: EBA Risk Dashboard.
6: Coverage ratios by geographical area as of June 2018 (weighted average). Source: EBA Transaprency Exercise 2018 and BBVA Research.
7: Coverage ratios by portfolios as of June 2018 (weighted average). Source: EBA Transaprency Exercise 2018 and BBVA Research.

In conclusion, the new prudential framework is likely to have a limited impact in the medium term due to the downward trend of NPL ratios (expected to be maintained) and the upward trend observed in coverage ratios. Therefore, once loans granted since 26th April 2019 enter into non-performing status, we could observe the first impacts. By portfolios, households is expected to be less impacted because (i) households' NPL ratio is lower that NFCs' (4% vs. 7%),(ii) a high proportion of the households' loan portfolio is subject to the ten-year coverage calendar due to the high percentage of loans secured with immovable property (highest quality collateral).

Finally, forborne exposures are included in the scope of the recently approved NPL regulation. This is relevant as the coverage ratio for forborne exposures that are non-performing (38%) is lower than the coverage ratio of total non-performing exposures (46%)[8]. In addition, the regulation requires NPL forborne to be classified in the category for at least one year, maintaining the 1-year probation period included in the common framework for NPL and forborne exposures. In this sense, some countries have coverage ratios for non-performing forborne exposures below 30% (Ireland, Netherlands, Denmark, Norway, Sweden and United Kingdom) which may result in higher provisions in these countries, thus reducing banks' incentives to provide forbearance measures in the event of a downturn.

8: Coverage for forborne exposures and total coverage expressed for comparison purposes in this paragraph are at closing date June 2018. Source: EBA Transparency Exercise 2018.

5. New SREP capital requirements in the eurozone marked by the activation of counter-cyclical buffers

Virginia Marcos

During the first months of the year, the European Central Bank informed eurozone banks of the new prudential minimum capital requirements in its supervisory environment; these requirements are applicable from 1 March 2019 and are the product of the Supervisory Review and Evaluation Process (SREP).

This level of minimum capital is the sum of different capital buffers and minimum capital requirements, which at the CET1 level are as follows:

- Pillar 1, a minimum of 4.5% of the total volume of risk-weighted assets (RWAs), standardised for all banks.
- Pillar 2 Requirement (P2R), calculated for each bank as a result of their ICAAP and ILAAP self-assessments and other supervisory assessments.
- The combined requirement for capital buffers, as the sum of the capital conservation buffer (2.5% in the European Union), counter-cyclical buffer (established by the national regulators as macro-prudential tool) and the largest of the systemic risk buffers, which include: being a Global Systemically Important Bank (G-SIB, established by the FSB), Other Systemically Important Institutions (O-SIIs), and the systemic risk buffer (SRB), both subject to national discretion.

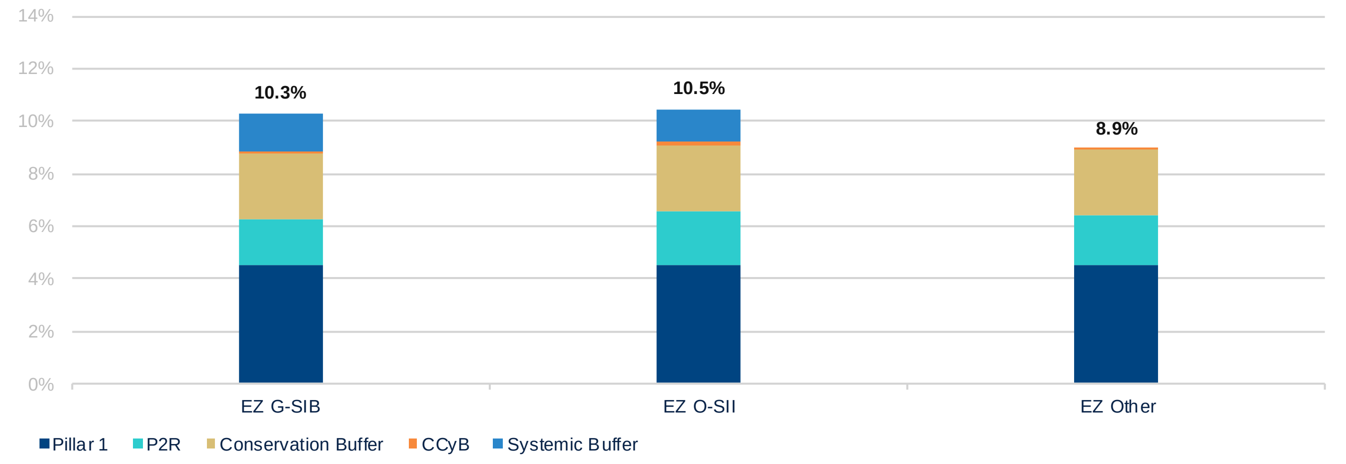
In the eurozone, for a sample of 48 banks, fully-loaded CET1 requirements are between 8% (banks with the lowest P2R requirement, 1%) and 14.1% (banks with a higher P2R requirement, over 3%, and with combined buffer requirements, over 6%).

The average SREP requirement for the sample examined is 10% (+11bps compared to 2018). In more than half of the banks studied, the SREP requirement has increased in comparison with last year, mainly due to the activation of counter-cyclical buffers in several European economies in 2018 and, to a lesser extent, to the P2R requirement, which, in comparison with last year, remains stable for 70% of the banks included in the sample.

If we group the banks based on their systemic risk, we can see (Figure 1) that, paradoxically, the average fully-loaded SREP CET1 requirement for O-SII banks is greater than that of G-SIB in the eurozone. This is explained by the fact that the P2R capital surcharge resulting from the supervisory process is higher in the sample of banks classified as O-SII than in the 8 banks in the eurozone identified as G-SIB. This also applies to banks not classified as systemic which have a P2R greater than that of G-SIB but less than that of the O-SII banks in the eurozone. However, as it is intuitive, the systemic buffer is greater in global systemically important banks than in other systemically important banks

The SREP requirements for all major Spanish banks, expressed in terms of the fully-loaded CET1 ratio, have risen by an average of 17pbs, up to 9%. The increase in requirements, observed in six of the twelve Spanish banks analysed, is driven by the greater requirements under pillar 2 and the activation of counter-cyclical buffers in countries where Spanish banks are present, such as the United Kingdom and, to a lesser extent, northern European countries.

Figure 1 Fully-loaded SREP requirements by category



Source: BBVA Research based on information supplied by banks

BBVA Research

Appendix 1: main indicators of the Spanish banking system

Table A1.1 Summarised balance sheet of the banking system (Billions of euros and percentage of variation)

									Growth rate		
Assets	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**Date**	**00-'08**	**08 - latest**	**y-on-y**
Total lending	1,716	1,651	1,603	1,556	1,532	1,514	1,492	Feb-19	217%	-31.4%	-1.1%
Public corporations	*87*	*101*	*90*	*88*	*78*	*69*	*70*	*Feb-19*	*69%*	*31.5%*	*-11.6%*
Domestic resident sector	*1,448*	*1,380*	*1,327*	*1,276*	*1,254*	*1,208*	*1,195*	*Feb-19*	*234%*	*-36.1%*	*-2.8%*
Non residents	*180*	*169*	*186*	*191*	*200*	*237*	*228*	*Feb-19*	*164%*	*-10.2%*	*13.4%*
Fixed income securities and equity stakes	773	754	662	610	589	562	572	Feb-19	132%	15.0%	-4.9%
Fixed income securities	*493*	*492*	*415*	*366*	*330*	*326*	*332*	*Feb-19*	*135%*	*1.8%*	*-4.4%*
Of which: sovereign debt	*264*	*288*	*251*	*225*	*206*	*200*	*206*	*Feb-19*	*6%*	*106%*	*-4.9%*
Equity	*280*	*262*	*246*	*244*	*259*	*236*	*241*	*Feb-19*	*128%*	*40.0%*	*-5.5%*
Interbank lending	211	155	164	163	235	212	206	Feb-19	81%	-21.8%	-1.3%
Other assets (net of interbank lending/deposits)	326	354	331	319	297	287	294	Feb-19	230%	2.5%	2.9%
Total assets	**3,026**	**2,913**	**2,760**	**2,647**	**2,652**	**2,576**	**2,564**	**Feb-19**	**184%**	**-20.5%**	**-1.5%**
Liabilities and Shareholders' Equity											
Customer deposits	1,684	1,686	1,637	1,578	1,539	1,549	1,534	Feb-19	169%	-23.8%	1.9%
Public corporations	*63*	*76*	*77*	*54*	*62*	*72*	*71*	*Feb-19*	*263%*	*-6.5%*	*16.4%*
Domestic resident sector	*1,314*	*1,289*	*1,261*	*1,243*	*1,203*	*1,213*	*1,212*	*Feb-19*	*192%*	*-15.4%*	*2.9%*
Non residents	*306*	*320*	*299*	*281*	*275*	*264*	*251*	*Feb-19*	*113%*	*-50.3%*	*-5.9%*
Interbank deposits	381	312	303	288	327	288	288	Feb-19	95%	-8.6%	-11.8%
Pro memoria: net interbank position	*171*	*157*	*139*	*125*	*93*	*76*	*82*	*Feb-19*	*215%*	*58.2%*	*-30.2%*
Debt issued	297	249	225	201	222	225	225	Feb-19	625%	-43.0%	0.7%
Other liabilities	430	436	368	352	330	291	295	Feb-19	253%	-7.7%	-8.0%
Shareholders' equity	233	230	227	227	232	223	223	Feb-19	134%	23.3%	-2.8%
Pro memoria: ECB funding	*207*	*142*	*133*	*140*	*167*	*168*	*167*	*Mar-19*	*566%*	*80.4%*	*-1.3%*
Total Liabilities and Shareholders' Equity	**3,026**	**2,913**	**2,760**	**2,647**	**2,652**	**2,576**	**2,564**	**Feb-19**	**184%**	**-20.5%**	**-1.5%**

(*) Includes ORS loans, loans to Public Administrations and loans to non-residents.
(**) Includes ORS deposits, deposits of the Public Administrations and deposits of non-residents.
Source: Bank of Spain Statistical Bulletin

Table A1.2 Summary balance sheet for the banking system
(Annual accumulated volume in billions of euros and percentage of variation)

									Growth rate		
	2012	2013	2014	2015	2016	2017	2018	Date	00-'08	08-latest	y-on-y
Net interest revenue	32,739	26,816	27,118	26,410	24,297	23,229	23,277	Dec-18	92%	-33.8%	0.2%
Net fees and commissions	11,275	10,931	11,257	11,237	11,062	11,751	12,165	Dec-18	79%	-6.6%	3.5%
Trading gains and other revenue	15,493	17,797	17,043	13,885	13,070	11,758	12,331	Dec-18	276%	-32.2%	4.9%
Total revenue	**59,507**	**55,544**	**55,418**	**51,532**	**48,429**	**46,737**	**47,774**	**Dec-18**	**118%**	**-28.0%**	**2.2%**
Operating expenses	-26,951	-26,798	-26,116	-26,261	-26,388	-26,667	-25,989	Dec-18	54%	-11.9%	-2.5%
Personnel expenses	-15,587	-15,108	-14,329	-14,182	-13,943	-13,935	-13,648	Dec-18	54%	-23.8%	-2.1%
Other operating expenses	-11,364	-11,690	-11,787	-12,079	-12,445	-12,733	-12,341	Dec-18	54%	6.3%	-3.1%
Pre-provision profit	**32,556**	**28,746**	**29,302**	**25,271**	**22,041**	**20,070**	**21,784**	**Dec-18**	**226%**	**-40.9%**	**8.5%**
Loan-loss provisions	-82,547	-21,800	-14,500	-10,699	-8,344	-9,127	-3,105	Dec-18	620%	-79.6%	-66.0%
Other income, net	-37,142	-2,789	-1,739	-3,819	-7,006	-11,586	-4,234	Dec-18	-299%	241.4%	-63.5%
Profit before taxes	-87,133	4,156	13,063	10,753	6,691	-643	14,445	Dec-18	108%	-29.2%	-2344.8%
Net attributable income	**-73,706**	**8,790**	**11,343**	**9,312**	**6,003**	**-3,916**	**12,377**	**Dec-18**	**122%**	**-32.8%**	**-416.0%**

Source: Bank of Spain Statistical Bulletin

Table A1.3. Relative size and resources of the system
(Percentage of GDP, number and percentage of variation)

									Growth rate		
	2013	2014	2015	2016	2017	2018	2019	Date	00-'08	08-latest	y-on-y
Lending to the private sector / GDP	139%	133%	123%	114%	108%	104%	99%	Feb-19	94%	-41.0%	-10.0%
Private sector deposits / GDP	126%	124%	117%	111%	103%	104%	100%	Feb-19	69%	-21.9%	-4.7%
Number of employees	217,878	208,291	202,961	194,283	192,626	n.a.	n.a.	Dec-17	14%	-30.8%	-0.9%
Number of branches	33,786	32,073	31,155	28,959	27,623	26,319	n.a.	Dec-18	17%	-43.0%	-4.7%

Source: Bank of Spain Statistical Bulletin

Table A1.4 Breakdown of ORS lending, NPLs and NPL ratios by portfolio (Billions of euros and percentage of variation)

									Growth rate		
Lending volume	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**Date**	**00-'08**	**08 - latest**	**y-on-y**
Loans to households	**756**	**715**	**690**	**663**	**652**	**647**	**647**	**Dec-18**	**236%**	**-21.1%**	**0.0%**
Of which:											
Housing loans	605	581	558	531	517	503	497	Dec-18	270%	-20.7%	-1.3%
Other loans to households	151	134	132	132	136	144	150	Dec-18	159%	-22.1%	4.5%
Lending to corporates and SMEs	**830**	**719**	**674**	**644**	**605**	**592**	**548**	**Dec-18**	**237%**	**-46.1%**	**-7.3%**
Of which:											
Lending to real estate	300	237	200	179	161	145	117	Dec-18	517%	-75.0%	-18.8%
Other lending to corporates and SMEs	530	482	474	465	444	447	431	Dec-18	142%	-21.2%	-3.6%
Total lending to domestic private sector *	**1,605**	**1,448**	**1,380**	**1,327**	**1,276**	**1,254**	**1,195**	**Feb-19**	**234%**	**-36.1%**	**-2.8%**
Non-performing loans											
Loans to households	**37.0**	**49.4**	**46.8**	**37.0**	**35.7**	**35.0**	**32.0**	**Dec-18**	**1062%**	**31.3%**	**-8.7%**
Of which:											
Housing loans	24.0	34.6	32.6	25.5	24.1	23.6	20.2	Dec-18	1878%	36.0%	-14.5%
Other loans to households	13.0	14.8	14.1	11.4	11.6	11.4	11.8	Dec-18	607%	24.1%	3.3%
Lending to corporates and SMEs	**128.4**	**146.1**	**124.6**	**94.2**	**79.2**	**60.7**	**37.3**	**Dec-18**	**818%**	**0.0%**	**-38.5%**
Of which:											
Lending to real estate	84.8	87.8	70.7	50.4	42.4	28.2	12.5	Dec-18	2790%	-53.5%	-55.8%
Other lending to corporates and SMEs	43.6	58.2	53.9	43.7	36.8	32.4	24.8	Dec-18	232%	138.1%	-23.5%
Total lending to domestic private sector *	**167.5**	**197.2**	**172.6**	**134.3**	**116.3**	**97.7**	**69.6**	**Feb-19**	**808%**	**10.3%**	**-27.6%**
NPL ratio											
Loans to households	**4.9%**	**6.9%**	**6.8%**	**5.6%**	**5.5%**	**5.4%**	**4.9%**	**Dec-18**	**246%**	**66.4%**	**-8.7%**
Of which:											
Housing loans	4.0%	6.0%	5.9%	4.8%	4.7%	4.7%	4.1%	Dec-18	434%	71.6%	-13.4%
Other loans to households	8.6%	11.1%	10.7%	8.7%	8.5%	7.9%	7.9%	Dec-18	173%	59.3%	-1.1%
Lending to corporates and SMEs	**15.5%**	**20.3%**	**18.5%**	**14.6%**	**13.1%**	**10.3%**	**6.8%**	**Dec-18**	**173%**	**85.5%**	**-33.7%**
Of which:											
Lending to real estate	28.2%	37.1%	35.3%	28.2%	26.4%	19.5%	10.6%	Dec-18	369%	86.0%	-45.5%
Other lending to corporates and SMEs	8.2%	12.1%	11.4%	9.4%	8.3%	7.3%	5.8%	Dec-18	37%	202.3%	-20.7%
Total lending to domestic private sector *	**10.4%**	**13.6%**	**12.5%**	**10.1%**	**9.1%**	**7.8%**	**5.8%**	**Feb-19**	**172%**	**72.6%**	**-25.5%**

(*) The total ORS credit incorporates total credit into homes, total credit for productive activities, non-for-profit institutions at the service of households (ISFLSH, for its acronym in Spanish) and unclassified credit. Since 2014, includes the credit to the banking entities.
Source: Bank of Spain Statistical Bulletin

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Table A1.5. New lending operations. Annual accumulated volume (Billions of euros and percentage of variation)

Lending volume	2013	2014	2015	2016	2017	2018	2019	Date	Growth rate 03-'08	08-'17	y-on-y
Loans to households	**51.2**	**60.5**	**75.7**	**80.6**	**87.6**	**96.2**	**23.4**	**Mar-19**	**0.7%**	**-48.3%**	**3.9%**
Of which:											
Housing loans	21.9	26.8	35.7	37.5	38.9	43.1	10.6	Mar-19	-15.6%	-50.6%	7.4%
Other loans to households	29.4	33.7	40.0	43.1	48.8	53.1	12.8	Mar-19	21.3%	-46.2%	1.3%
Lending to corporates and SMEs	**392.6**	**357.2**	**392.6**	**323.6**	**339.0**	**347.2**	**78.0**	**Mar-19**	**29.2%**	**-62.6%**	**-7.3%**
Of which:											
Less than €250,000	106.1	112.3	128.7	133.6	143.4	137.0	32.1	Mar-19	n.d.	-16.6%	-6.7%
Between €250,000 and €1million)	28.3	34.0	36.8	36.3	40.6	38.2	9.3	Mar-19	n.d.	-16.9%	6.3%
Corporates (loans > €1mill.)	258.2	210.3	227.2	152.6	155.1	171.9	36.6	Mar-19	43.5%	-70.0%	-10.7%
Total new lending flows	**444**	**418**	**468**	**404**	**427**	**443**	**101**	**Mar-19**	**23%**	**-60.2%**	**-4.9%**

Source: Bank of Spain

Table A1.6 Information on resident deposits (Billions of euros and percentage of variation)

	2013	2014	2015	2016	2017	2018	2019	Date	Growth rate 00-'08	08 - latest	y-on-y
Sight deposits	500	563	650	754	857	931	940	Feb-19	90%	113.4%	10.1%
Term deposits	677	597	509	404	286	231	227	Feb-19	272%	-69.4%	-15.5%
Total retail deposits	**1,177**	**1,160**	**1,159**	**1,157**	**1,143**	**1,163**	**1,168**	**Feb-19**	**163%**	**-1.3%**	**4.0%**
Other deposits											
Repurchase agreements	64	60	42	32	28	23	16	Feb-19	-23%	-80.7%	-32.0%
Funds from financial asset transfers	37	32	25	23	21	20	20	Feb-19	14%	-78.1%	-3.3%
Hybrid financial liabilities	16	22	17	14	10	7	7	Feb-19	33%	-75.2%	-21.5%
Subordinated deposits	20	16	18	16	1	0	0	Feb-19	n.m.	-99.2%	-9.4%
Pro-memoria: Deposits in foreign currency	*30*	*27*	*29*	*28*	*17*	*15*	*16*	*Feb-19*	*739%*	*-56.8%*	*-12.4%*
Total deposits of domestic resident sector	**1,314**	**1,289**	**1,261**	**1,243**	**1,203**	**1,213**	**1,212**	**Feb-19**	**159%**	**-15.4%**	**2.9%**

Source: Bank of Spain Statistical Bulletin

Table A1.7 Interest rates for lending (Percentage and variation in basis points)

	2013	2014	2015	2016	2017	2018	2019	Date	Growth rate (bps) 03-'08	08 - latest	y-on-y
Loans. Stock (NDER)											
Loans to households											
Housing loans	2.11	1.89	1.53	1.30	1.21	1.22	1.24	Mar-19	178	-441	5
Other loans to households	5.80	6.10	5.98	6.17	6.24	6.26	6.30	Mar-19	113	-77	10
Loans to corporates and SMEs	3.44	2.84	2.38	2.04	1.89	1.86	1.85	Mar-19	204	-371	-5
Loans. New lending transactions (APRC)											
Loans to households											
Housing loans	3.16	2.64	2.31	2.19	2.05	2.24	2.39	Mar-19	238	-344	12
Consumer loans	9.52	9.10	8.45	8.06	8.27	8.32	8.56	Mar-19	237	-244	-14
Other	5.92	4.93	4.19	4.27	4.01	3.72	4.28	Mar-19	224	-276	59
Loans to corporates and SMEs (Synthetic average)	3.57	2.73	2.58	2.29	2.12	1.97	2.12	Mar-19	112	-275	4
Less than €250,000	5.54	4.53	3.59	3.28	2.93	2.67	2.67	Mar-19	n.a.	-188	-15
Between €250,000 and €1million)	4.03	2.91	2.20	1.91	1.80	1.70	1.70	Mar-19	n.a.	-219	-5
Corporates (loans > €1mill.)	2.83	2.10	2.07	1.63	1.56	1.59	1.75	Mar-19	n.a.	-96	10

NDER: Narrowly defined effective rate (APR without bank charges).
APR: Annual percentage rate.
Source: Bank of Spain Statistical Bulletin

Table A1.8 Interest rate on deposits (Percentage and variation in basis points)

	2013	2014	2015	2016	2017	2018	2019	Date	Growth rate (bps) 03-'08	08 - latest	y-on-y
Deposits. Stock (NDER)											
Households deposits											
Sight deposits	0.22	0.17	0.12	0.06	0.04	0.04	0.04	Mar-19	6.5	-65	0
Term deposits	2.08	1.39	0.75	0.30	0.16	0.12	0.11	Mar-19	232	-429	-4
Corporates and SMEs deposits											
Sight deposits	0.35	0.31	0.24	0.15	0.10	0.08	0.07	Mar-19	111	-171	-3
Term deposits	1.93	1.40	0.91	0.65	0.77	0.63	0.68	Mar-19	223	-370	-7
Deposits. New transactions (NDER)											
Households deposits											
Sight deposits	0.22	0.17	0.12	0.06	0.04	0.04	0.04	Mar-19	30	-65	0
Term deposits	1.50	0.66	0.39	0.11	0.08	0.06	0.05	Mar-19	225	-414	-4
Corporates and SMEs deposits											
Sight deposits	0.35	0.31	0.24	0.15	0.10	0.08	0.07	Mar-19	111	-171	-3
Term deposits	1.31	0.51	0.31	0.13	0.16	0.37	0.31	Mar-19	146	-316	7

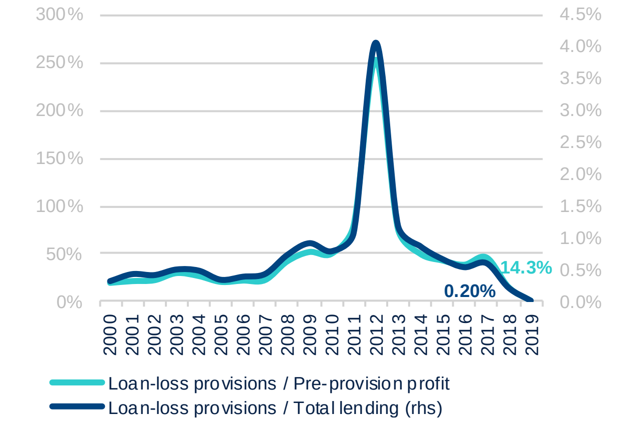
NDER: Narrowly defined effective rate (APR without bank charges).
APR: Annual percentage rate.
Source: Bank of Spain Statistical Bulletin

Table A1.9 Main ratios

	2013	2014	2015	2016	2017	2018	2019	Date	Growth rate 00-'08	08-latest	y-on-y
Productivity											
Business volume* per branch (€'000)	81,761	83,229	83,085	86,975	88,942	91,993	n.a.	Feb-19	168.2%	28.6%	5.6%
Profit before tax per branch (€'000)	123	407.3	345.2	231.1	-23	548.8	n.a.	Dec-18	77.5%	24.3%	-2456.0%
Efficiency											
Cost-to-Income ratio (Oper. expenses / Total revenue)	48.2%	47.1%	51.0%	54.5%	57.1%	54.4%	n.a.	Dec-18	-29.3%	22.4%	-4.7%
Operating expenses / ATA	0.83%	0.88%	0.93%	0.98%	1.01%	0.99%	n.a.	Dec-18	-43.4%	4.0%	5.0%
Profitability											
RoE	4.1%	4.9%	4.1%	2.6%	-1.7%	5.4%	n.a.	Dec-18	-3.4%	-47.5%	-419.1%
RoA	0.13%	0.44%	0.38%	0.25%	-0.02%	0.55%	n.a.	Dec-18	-23.6%	-16.4%	-2424.0%
NIM (Net interest rev. / ATA)	0.83%	0.91%	0.93%	0.90%	0.88%	0.89%	n.a.	Dec-18	-29.6%	-21.9%	3.7%
Liquidity											
Loans-to-Deposits (resident sector)	123%	119%	115%	110%	110%	104%	102%	Feb-19	14.8%	-34.2%	-5.0%
Funding gap (Loans - Deposits, EUR bn)	270.9	220.1	168.3	118.9	110.4	45.6	27.3	Feb-19	349%	-93.4%	-56.9%
Funding gap / Total assets	9.0%	7.6%	6.1%	4.5%	4.2%	1.8%	1.1%	Feb-19	57.7%	-91.7%	-56.5%
Solvency and Asset Quality											
Leverage (Shareholders' equity / Total assets)	7.7%	7.9%	8.2%	8.6%	8.8%	8.7%	8.7%	Feb-19	-17.8%	54.5%	-1.5%
Shareholders' equity / NPLs	118%	133%	169%	196%	238%	317%	320%	Feb-19	-74.3%	10.8%	33.1%
Provisioning effort (Loan-loss prov. / Pre-provision profit)	75.8%	49.5%	42.3%	37.9%	45.5%	14.3%	n.a.	Dec-18	121%	-65.5%	-68.7%
Cost of Risk (Loan-loss provisions / total lending)	1.19%	0.86%	0.66%	0.53%	0.59%	0.20%	n.a.	Dec-18	134%	-71.7%	1.5%
NPL ratio (resident sector)	13.6%	12.5%	10.1%	9.1%	7.8%	5.8%	5.8%	Feb-19	172%	73%	-25.5%
NPL coverage ratio (total)	58.0%	58.1%	58.9%	58.9%	60.0%	61.0%	61.5%	Feb-19	-58.2%	-13.8%	-6.1%
NPL coverage ratio (specific provisions)	46.9%	46.7%	47.0%	46.2%	42.1%	41.5%	n.a.	Dec-18	-39.0%	38.7%	17.3%

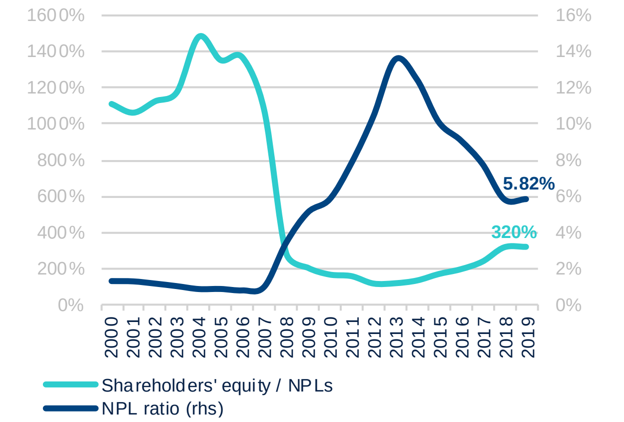
(*) ORS loans plus ORS deposits.
Source: Bank of Spain Statistical Bulletin

Figure A1.1 Effort made in recording provisions



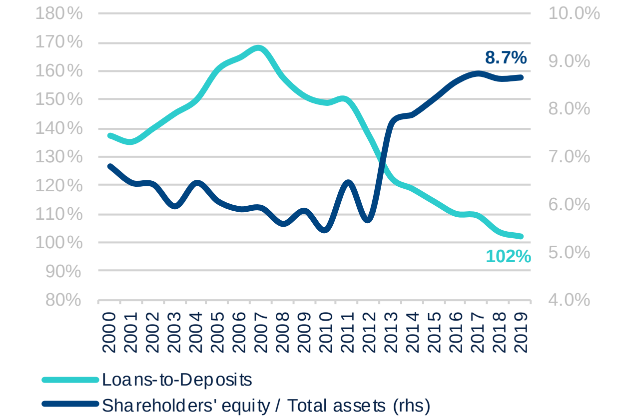
Source: BBVA Research

Figure A1.2 Default and capital as a percentage of non-performing loans



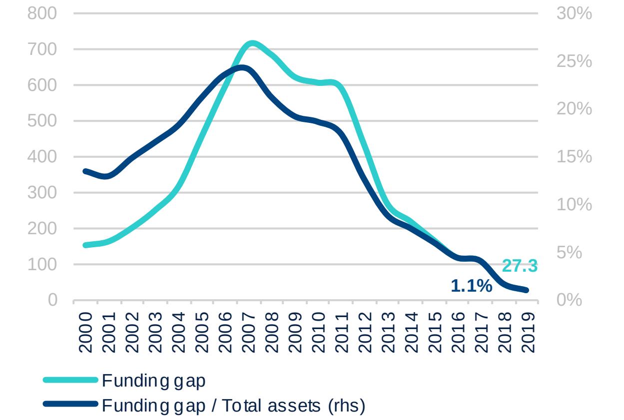
Source: BBVA Research

Figure A1.3 Liquidity and leveraging



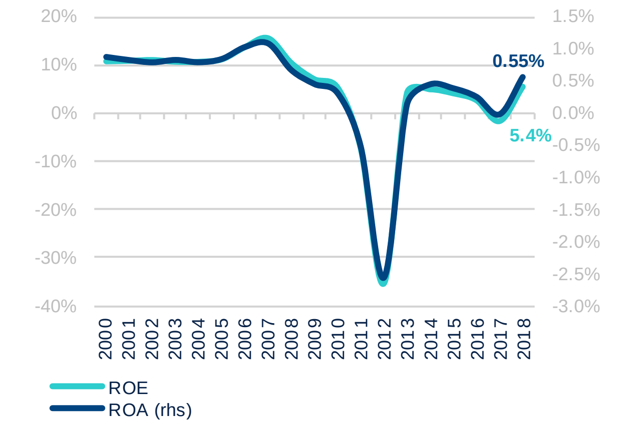
Source: BBVA Research

Figure A1.4 Funding gap (Loans minus deposits)



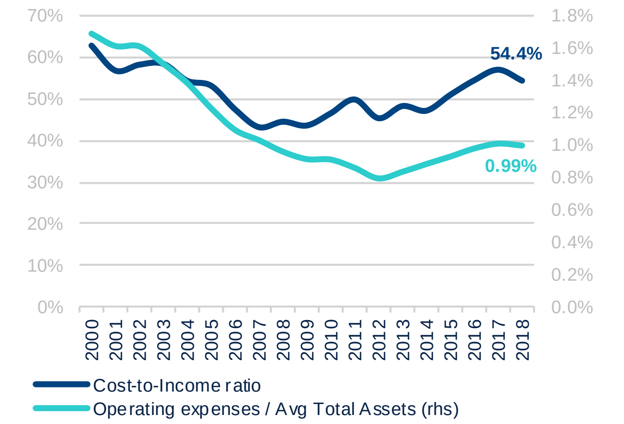
Source: BBVA Research

Figure A1.5 Returns



Source: BBVA Research

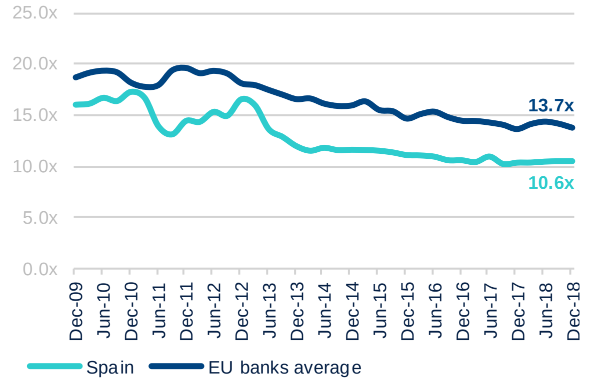
Figure A1.6 Efficiency



Source: BBVA Research

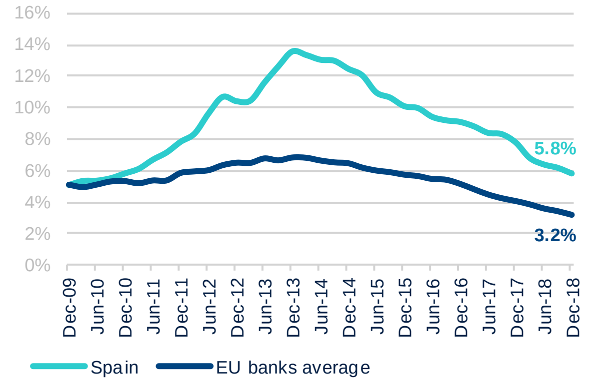
Appendix 2: comparative Analysis with the European Union

Figure A2.1 Total balance-sheet liabilities / capital



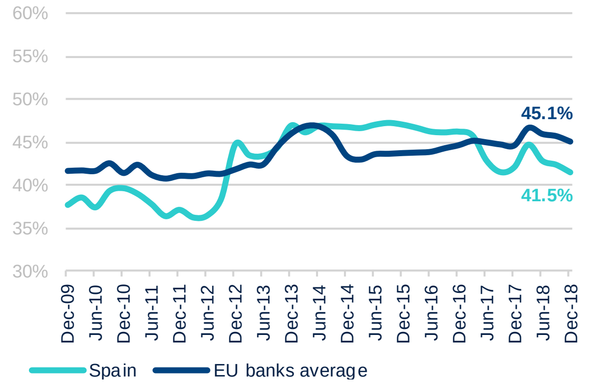
Source: EBA, Bank of Spain, BBVA Research

Figure A2.2 Non-performing loan ratio



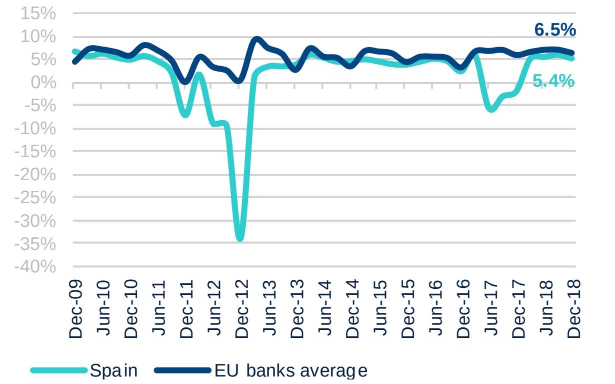
Source: EBA, Bank of Spain, BBVA Research

Figure A2.3 Coverage ratio (Only specific provisions)



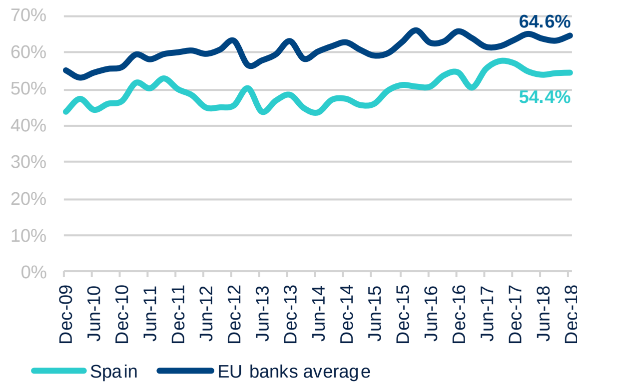
Source: EBA, Bank of Spain, BBVA Research

Figure A2.4 ROE



Source: EBA, Bank of Spain, BBVA Research

Figure A2.5 Efficiency ratio



Source: EBA, Bank of Spain, BBVA Research

Note: the data on averages of European banks comes from the EBA Risk Dashboard, composed of a panel of 150 major European banks, representing 80% of all system assets.

DISCLAIMER

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