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# Post-Programme Surveillance Report

## Spain, Autumn 2020

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European Commission  
Directorate-General for Economic and Financial Affairs

# Post-Programme Surveillance Report

## Spain, Autumn 2020

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<sup>(1)</sup> The executive summary of this report was adopted as Commission Communication C(2020) 8039 on 16 November 2020. The rest of the report is the Staff Working Document SWD(2020) 278 accompanying this Communication.

## CONTENTS

Executive Summary	5
1. Introduction	7
2. Macroeconomic developments	9
3. Financial sector trends	12
4. Financial sector reforms and policy	16
4.1. Measures to mitigate the impact of the pandemic on the banking sector	16
4.2. Progress with financial sector reforms and challenges ahead	16
4.3. SAREB – recent developments and outlook	17
A. Main macroeconomic and financial indicators	19

## LIST OF TABLES

A.1. Main macroeconomic and financial indicators	19
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## LIST OF GRAPHS

2.1. Composition of GDP growth	9
3.1. IBEX35, STOXX 600 Banks and selected Spanish banks stocks	12
3.2. Sovereign spreads to the 10-year German bund	12
3.3. Bank deposits	13
3.4. Bank loans to the private sector	13
3.5. Ratio of non-performing loans	14
3.6. Bank sector profitability for domestic operations	15

## ABBREVIATIONS

BdE	Banco de España, Bank of Spain
BFA	Banco Financiero y de Ahorros, S.A.
CDS	Credit Default Swaps
CET 1	Common Equity Tier 1
COVID-19	Coronavirus disease 2019
CSRs	Country-Specific Recommendations
EBA	European Banking Authority
ECB	European Central Bank
ERTEs	Expedientes de Regulación Temporal de Empleo, short-time work schemes
ESM	European Stability Mechanism
FROB	Fondo de Reestructuración Ordenada Bancaria, Fund for Orderly Bank Restructuring
GDP	Gross domestic product
HICP	Harmonised Index of Consumer Prices
ICO	Instituto de Crédito Oficial, a state owned bank
MFIs	Monetary Financial Institutions
MIP	macroeconomic imbalances procedure
MREL	Minimum Requirement for own funds and Eligible Liabilities
NFCs	non-financial corporations
NPLs	Non-Performing Loans
PPS	Post-programme surveillance
RED	Real Estate Development
REO	Real Estate Owned
ROA	Return on Assets
ROE	Return on Equity
RRF	Recovery and Resilience Facility
Sareb	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A.
SMEs	Small and Medium-sized Enterprises
SSM	Single Supervisory Mechanism
SURE	European instrument for temporary support to mitigate unemployment risks in an emergency following the Covid-19 outbreak

## EXECUTIVE SUMMARY

**This fourteenth surveillance report provides an assessment of Spain's economic and financial situation following its exit from the financial assistance programme in January 2014.** Staff from the European Commission, in liaison with the European Central Bank <sup>(2)</sup>, held virtual meetings with the Spanish authorities in early-October in preparation of the present report. The ESM participated in the meetings on aspects related to its own Early Warning System. Following the COVID-19 related social distancing measures and travel restrictions, the meetings were held in the form of video conferences with the Spanish authorities. The report focuses on macroeconomic and financial sector developments over the past months, complementing the surveillance by the Commission under the European Semester of economic policy coordination.

**Spain is set to experience a sharp economic downturn in 2020, followed by a rebound in 2021.** The outbreak of the COVID-19 pandemic in March 2020 had a negative impact on economic activity, after the moderating growth path experienced over the previous quarters. GDP growth stood at 2.0% in 2019, well above the euro area average (1.2%). The disruption to economic activity caused by the pandemic, coupled with the necessary containment measures put in place as of March, resulted in an unprecedented contraction in economic activity in the first half of 2020. With restrictions lifted gradually as of May, output is forecast to rebound in the third quarter, but the new restrictions needed to contain the resurgence of outbreaks are set to dampen growth in the last quarter of 2020 and early 2021, as projected in the European Commission 2020 autumn forecast. Activity in the services sector, in particular tourism-related activities, is the most severely hit and will be slower to resume. This forecast is subject to large uncertainty, namely relating to the impact of the new pandemic outbreaks experienced since the end of the summer, the future developments of the pandemic, containment measures linked to those, and households' and firms response. Measures to limit job losses and support corporate liquidity and households' income are cushioning the impact of the crisis. Still, the unemployment rate is expected to rise sharply in 2020. Job losses are expected to be partly reabsorbed as activity picks up again.

**While government policies have mitigated the impact of the pandemic, the overall fiscal cost has been considerable.** The severe economic downturn and the actions taken by the government, in line with EU guidance, to minimise the economic and social consequences of the crisis are set to worsen the fiscal balance and lead to a significant increase in the debt-to-GDP ratio in 2020. The government intends to continue its supportive stance into 2021 to ensure the recovery is well under way, also on account of the significant EU funding through EU Cohesion Funds and the Resilience and Recovery Facility. Envisaged measures are expected to lift economic activity while preserving a sustainable evolution of the government deficit and debt. The latter nevertheless calls for continued attention on the part of the authorities and for action to improve the quality and effectiveness of public finances further.

**The full impact of the coronavirus crisis on the Spanish financial sector continues to be uncertain, although stability has been maintained thanks to support measures introduced by the authorities and resilience built over the past decade.** The banking sector entered the crisis with much more robust balance sheets than in 2008, with strong liquidity and adequate capitalisation. Although the reduction in non-performing loans (NPLs) has slowed down lately, there have not been any significant inflows of new NPLs due to the support measures (payment moratoria and public guarantees) that were introduced by the authorities and the banking sector. A significant proportion of new business loans granted in the first half of 2020 are covered by public guarantees, which have effectively ensured that businesses can continue to cover their liquidity needs. While these temporary measures have been very effective in the short term, they will have to be complemented with more structural measures, such as effective debt resolution and restructuring frameworks for the corporate sector. The current support schemes can mitigate credit risks only partially and the asset quality in the banking sector is likely to worsen over the upcoming months, especially if further confinement measures become necessary. Furthermore, Spanish banks continue to

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<sup>(2)</sup> European Central Bank (ECB) Staff participated in this mission, and in the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

operate in a challenging environment to maintain profitability, which has become even more acute in recent months due to booking in advance of provisions. Meanwhile, consolidation in the banking sector has regained momentum, especially following the announcement of the proposed merger of Bankia and Caixabank. SAREB has continued to implement its new strategy, although it continues incurring losses, while the pandemic is expected to put additional strain on the real estate market and SAREB's business.

**Spain retains the capacity to service its ESM debt.** The resilience of Spain's economy and financial sector upon entering the COVID-19 crisis and the support provided by the Eurosystem, as well as Spain's enhanced debt profile, reduce the vulnerabilities that stem from the increase in gross government debt. The implementation of a significant package of reforms and investment funded by the Recovery and Resilience Facility is also expected to further increase the growth potential and resilience of the economy underpinning its transformation and the twin green and digital transitions. Recent debt auctions have shown continued investor trust in Spain's economy and sovereign debt in spite of the COVID-19 outbreak.



# 1. INTRODUCTION

**1. Spain successfully exited the financial assistance programme for the recapitalisation of financial institutions in January 2014.** The Programme was agreed by the Eurogroup on 9 July 2012 for a period of 18 months<sup>(3)</sup> and provided financing by the euro area Member States of up to EUR 100 billion. Eventually, Spain used EUR 38.8 billion for bank recapitalisation, under restructuring and resolution plans approved by the European Commission consistently with State-aid rules, and around EUR 2.2 billion for capitalising SAREB, the Spanish asset management company<sup>(4)</sup> repayments. Between July 2014 to October 2020, Spain made nine voluntary early repayments.

**2. The outstanding amount of the ESM loan stands at EUR 23.7 billion, which represents 57% of the total amount disbursed to Spain under the programme.** The Post-programme surveillance (PPS) aims at a broad monitoring, on a biannual basis, of the repayment capacity of a country having received financial assistance<sup>(5)</sup>,<sup>(6)</sup>. There is no policy conditionality under the PPS, although the Council can issue recommendations for corrective actions if deemed necessary and appropriate.

**3. Staff from the European Commission, in liaison with the European Central Bank, carried out the 14<sup>th</sup> PPS mission, holding meetings with the Spanish authorities between 30 September and 7 October 2020, with the main findings presented in the present report<sup>(7)</sup>.** The ESM participated in the meetings on aspects related to its own Early Warning System. Following the COVID-19 related social distancing measures and travel restrictions, the

meetings were held in the form of video conferences with the Spanish authorities.

**4. The autumn 2020 PPS focuses on the Spanish financial sector, complementing the surveillance under the European Semester of economic policy coordination.** As part of the latter, the 2020 Country Report for Spain<sup>(8)</sup> was published on 26 February 2020. It included an In-Depth Review on the prevention and correction of macroeconomic imbalances under Article 5 of Regulation (EU) No 1176/2011<sup>(9)</sup>.

The Commission's analysis in that review led it to conclude that Spain still experiences large, though declining, stocks of external and internal debt, amid high unemployment. These imbalances have cross-border relevance<sup>(10)</sup>. However, since the Country Report was published, Spain witnessed the outbreak of the COVID-19 pandemic, along with other EU countries. The pandemic, and the necessary measures put in place by the government as of mid-March to stem its spread, are set to have an unprecedented negative impact on the Spanish and EU economies in 2020. On 20 March 2020, the Commission adopted a Communication on the activation of the general escape clause of the Stability and Growth Pact. This allows for a temporary departure from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term. The Country-specific Recommendations (CSRs) adopted by the Council of the European Union on 20 May 2020, call on Spain<sup>(11)</sup> to take all necessary measures to effectively address the pandemic and support the ensuing recovery, and strengthen the health system's resilience, as well as pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability. The CSRs also recommend Spain to support employment, reinforce unemployment protection, family support and coverage and adequacy of minimum income schemes, as well as access to digital learning. Measures to provide liquidity to

<sup>(3)</sup> However, the completion of the restructuring of the banks receiving public support under the State aid rules was due to take place after the exit from the programme.

<sup>(4)</sup> For more details see the report: [https://ec.europa.eu/info/publications/economy-finance/evaluation-financial-sector-assistance-programme-spain-2012-2014\\_en](https://ec.europa.eu/info/publications/economy-finance/evaluation-financial-sector-assistance-programme-spain-2012-2014_en).

<sup>(5)</sup> PPS is foreseen by Art. 14 of the Two-Pack Regulation (EU) N°472/2013. It starts automatically after the expiry of the programme and lasts at least until 75% of the financial assistance has been repaid.

<sup>(6)</sup> The previous PPS report was published as Institutional Paper 128 in May 2020: [https://ec.europa.eu/info/publications/post-programme-surveillance-report-spain-spring-2020\\_en](https://ec.europa.eu/info/publications/post-programme-surveillance-report-spain-spring-2020_en).

<sup>(7)</sup> The cut-off date for the data included in this report is 30 October 2020.

<sup>(8)</sup> <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:52020SC0508>

<sup>(9)</sup> <http://data.europa.eu/eli/reg/2011/1176/oj>

<sup>(10)</sup> <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:52020DC0150>

<sup>(11)</sup> [https://ec.europa.eu/info/publications/2020-european-semester-country-specific-recommendations-commission-recommendations\\_en](https://ec.europa.eu/info/publications/2020-european-semester-country-specific-recommendations-commission-recommendations_en)

small and medium-sized enterprises and the self-employed are also recommended, as well as to promote private investment to foster the economic recovery, and focus investment on the green and digital transition, while fostering innovation and resource efficiency.

**5. The European Council has agreed on several financial packages to support the recovery.** In mid-July the European Council agreed on a new Multiannual Financial Framework and a recovery package amounting to EUR 750 billion. The largest part of it will go to the Recovery and Resilience Facility <sup>(12)</sup> (RRF, EUR 672.5 billion), which aims at supporting investments and reforms in the Member States. This facility will be disbursed in the form of grants (EUR 312.5 billion) and loans (EUR 360 billion). Spain is expected to receive EUR 59.2 billion in grants and may request up to EUR 140 billion <sup>(13)</sup> in grants and loans from the Recovery and Resilience Facility. Negotiations on the legislative text are still ongoing but it is expected that first disbursements can take place by mid-2021. On 25 September, the Council also adopted proposals by the Commission for implementing decisions to grant financial support of EUR 87.3 billion to 16 Member States, amongst it Spain, under the SURE instrument <sup>(14)</sup>. Spain will be financed by a maximum amount of EUR 21.3 billion to cover the costs related to the financing of national short-time work schemes incurred in 2020.

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<sup>(12)</sup> [COM \(2020\) 408](#): Proposal for a regulation of the European Parliament and of the Council establishing a Recovery and Resilience Facility

<sup>(13)</sup> Expressed in terms of 2018 prices.

<sup>(14)</sup> [Council Regulation \(EU\) 2020/672](#) of 19 May 2020 on the establishment of a European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) following the COVID-19 outbreak.

## 2. MACROECONOMIC DEVELOPMENTS

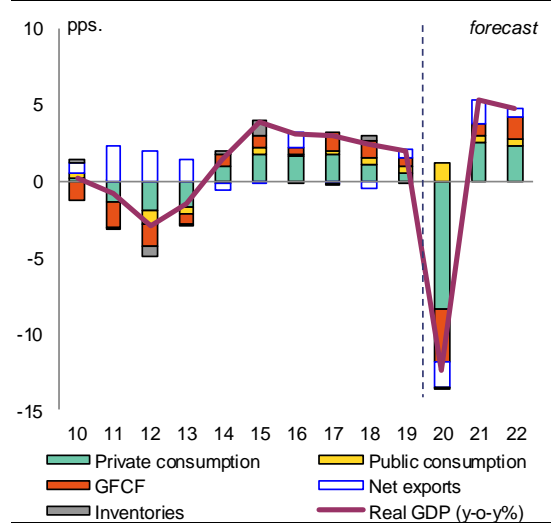
**6. Economic activity in Spain experienced an unprecedented decline in the first half of 2020, followed by a marked rebound in the third quarter.** The severe outbreak of the COVID-19 pandemic in Spain and the strict confinement measures taken in response resulted in an unprecedented decline of GDP in the first half of the year (21.5%, year-on-year). The gradual lifting of the lockdown and the easing of containment measures allowed economic activity to resume over the second quarter, as shown by the strong rebound in manufacturing and services indicators in May and June. Following a fast pick up in activity in early summer, the pace of recovery slowed down in August and September. The resurgence of numerous outbreaks in those months prompted the subsequent adoption of social distancing and other containment measures. Still, economic indicators point to a strong rebound of GDP growth in the third quarter, as confirmed by the flash estimate (16.7% quarter-on-quarter), which is expected largely to moderate in the last quarter of the year .

**7. The outlook for the Spanish economy largely depends on the evolution of the pandemic, the related containment measures, the progress in vaccines and treatments, the reaction of the private sector and future public policies.** The recovery over the second half of 2020 is expected to remain uneven across sectors. Manufacturing production picked up fast and is expected to continue growing in the near future, though at a more moderate pace, while transport and social-interaction sectors -such as leisure and tourism-related activities- are recovering at a much slower pace. After the reintroduction of heightened containment measures in late 2020, and under the assumption of gradually less stringent and more targeted measures than in the initial phase remaining in place over 2021, real GDP is expected to contract 12.4% % in 2020 as a whole, and expand by 5.4% in 2021 and 4.8% in 2022, based on the European Commission autumn forecast <sup>(15)</sup>. As a consequence, output at the end of 2022, will remain 3% below its pre-pandemic 2019 level. This forecast is subject to a larger degree of uncertainty than in normal times. The uncertainty relates to the possibility and duration

<sup>(15)</sup> The cut-off date for the European Commission 2020 autumn forecast was 22 October 2020.

of a resurgence of new pandemic waves over the next months, the response of private agents to the potential containment measures, the progress in vaccines and treatments, and public measures to contain the impact of the pandemic and to support the recovery.

Graph 2.1: Composition of GDP growth



GFCF: gross fixed capital formation

Source: INE, European Commission Economic Forecast, autumn 2020.

**8. Policy measures have mitigated the impact of the crisis on households' income and corporate liquidity, and will shape the magnitude of the recovery over the next few years.** Short-time work schemes (named 'ERTEs' in Spain) were made more attractive for employers so as to mitigate job losses during the confinement period. They have been extended several times and are currently legislated to be in place until the end of January 2021, though more targeted to the firms or sectors most affected by the containment measures. In addition, several measures were taken to protect the self-employed by means of tax deferrals and benefits for suspension of activity, which have also been extended until January 2021. These schemes have contributed to contain job losses but not to avoid them altogether. Hence, the fall in employment will push the unemployment rate up to 16.7% in 2020. Only part of this increase will be reversed in 2021, to nearly 17%, since the severe impact of the crisis on labour intensive-sectors may still result in additional job losses and high unemployment, while further increases cannot be ruled out once ERTes are phased out. In order

to provide firms with liquidity, the authorities launched a program of public guarantees for new bank loans, allowed tax deferrals and introduced payment moratoria on existing bank loans. The take-up of loans backed by public guarantees has been high (about 75%), which is expected to help firms have sufficient liquidity to cushion the fall in revenues while demand is gradually strengthening. Nevertheless, impaired profitability could lead to the materialization of corporate insolvencies and downside risks to productive capacity. The Spanish authorities have announced a policy package to be funded by the Recovery and Resilience Facility. The Commission forecast does not incorporate its potentially significant positive impact on economic growth. According to government estimates, based on full and swift absorption of the package and an aggregate multiplier of 1.2, it would increase real GDP growth by up to 2.5 pps in 2021.

**9. Domestic demand is set to remain the main driver of GDP developments this year and the next.** Private consumption and investment are expected to sharply drop in 2020, as spending was put on hold during the confinement period. After the rebound triggered by pent-up demand throughout the summer, consumer spending will gradually moderate in the following quarters. Household savings rates are expected to decrease after having peaked in 2020, due to the “forced savings” accumulated during the lockdown. However, uncertainty regarding the dynamics of the pandemic and its potential impact on employment are likely to keep precautionary savings above pre-crisis levels in 2021 and 2022. Increased uncertainty on the pandemic and on demand strengthening will also weigh on investment decisions in 2021. Exports are expected to shrink strongly in 2020, in the context of declining global growth and a severe impact of the crisis on the tourism sector. Though imports will also contract this year, the contribution of net exports to growth is expected to be negative in 2020, before turning positive in 2021 as trade flows recover and inbound tourism rebounds.

**10. The lockdown weighed on activity and prices in the housing market, with a heterogeneous impact in local rental markets.** The lockdown led to a sizeable reduction of activity in the housing market during the first half of the year. Housing supply and building permits

declined by 16.1% and 18.6% y-o-y., respectively, in the second quarter of 2020, while the number of dwelling transactions plummeted by 46.5%, between March and May with respect to the same period in 2019. Once the containment measures eased, transactions resumed in the following months, thus moderating the fall with respect to the previous year (still down 11.0% in August). The pace of recovery was faster in rural areas (+5.2% y-o-y) than in urban areas (14.7% y-o-y), possibly reflecting a quicker release of COVID-19 restrictions and a shift in housing demand towards rural areas. While mortgage interest rates declined by 0.1 pps to 1.9%, the Bank Lending Survey reported a tightening of the conditions for mortgage approvals as a result of a higher risk perception. Annual house price inflation eased to 2.1% in the second quarter, the lowest value since the first quarter of 2015, and is expected to further ease in the near future due to lower housing demand. Prices in the rental market were still growing country-wide in September 2020 (5.7% y-o-y), according to some real estate portals. The pent-up demand built during the lockdown period, and the income support measures put in place by the government may help explain these developments. A different pattern is observed in big cities and some touristic areas –Madrid, Balearic and Canary Islands- where rental prices declined and the stock of rental homes increased as a result of landlords renting to tourists reverting to the regular rental market <sup>(16)</sup>.

**11. Headline inflation is expected to increase gradually.** In the second half of 2020, inflation will remain very low, with negative values, dominated by the fall in energy prices, the effect of weaker consumer demand and the appreciation of the euro. The higher energy prices forecast in 2021 will increase HICP inflation to 0.9%, based on the European Commission autumn forecast. Domestic cost pressures are expected to be rather weak in 2021, reflecting a more deteriorated labour market situation, which will keep wage pressures rather muted.

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<sup>(16)</sup> According to the INE, the number of touristic apartments between August 2019 and September 2020 has sharply declined in Canary Islands (-39%), Balearic Islands (-37%) and Madrid (-21%) but vigorously increased in Castile and Leon (+35%), Navarre (+17%), Murcia (+15%) and Galicia (+12%).

**12. The economic downturn has contributed to a deterioration of the fiscal balance.**

In 2019, the general government deficit widened from 2.5% to 2.8% of GDP, the first increase in the deficit since 2012 despite favourable growth. The disruption in economic activity and the measures put in place to preserve employment and protect workers and households have had a strong impact on the general government deficit in the first half of 2020. The contraction of the tax bases led to a significant drop in revenues, while unemployment benefits and other social transfers have been growing fast due to the increase in unemployment and the ample use of short-time work and other income support schemes. Together with increased health expenditure to cope with the pandemic and the increase in pensions and public sector pay stipulated for 2020, the deficit is expected to reach about 12% of GDP in 2020, before narrowing to 9.6% and 8.6% of GDP in 2021 and 2022, respectively, in line with the gradual recovery of the economy and the phasing out of short-term support measures.

**13. The government debt ratio is set to increase significantly, but mitigating factors and the support provided by the Eurosystem reduce the vulnerabilities of public finances.**

The European Commission 2020 autumn forecast projects the general government debt-to-GDP ratio to rise by around 25 percentage points in 2020, to 120.3%, compared to one year earlier, before falling back to about 122% in 2021 and slightly increasing to almost 124% in 2022, respectively. The impact of the recession and fiscal support measures also imply significantly higher government financing needs in 2020 (to around 25% of GDP, from slightly above 15% in 2019) and, to lesser extent, in 2021 and 2022. However, market conditions for financing debt remain favourable so far, with the most recent debt auctions in September and October confirming comfortable demand for both long and short-term government securities. Yields on 10-year bonds are very low by historical standards, and spreads against the 10-year German bund remain contained (see Chapter 3). The interest burden, both as a percentage of GDP and of total revenues (2.2% and 5.8%, respectively, in 2019) has fallen in the past 6 years to levels not seen since 2010, despite the fact that the total debt stock has almost doubled since that time. Asset purchases by the Eurosystem on the secondary market are expected to continue to stabilize the

sovereign debt market. In addition, the government debt profile mitigates vulnerabilities. Its average maturity has lengthened over time, reaching almost 7.8 years in October 2020, which makes it likely that interest payments would remain contained by historical standards throughout the projection period even under more adverse conditions.

**14. The private sector debt ratio has recently increased, and deleveraging needs persist.**

The debt ratio of the non-financial private sector increased by 11.4 pps in the second quarter of 2020, up to 141.2% of GDP in consolidated terms, of which 60.6% of GDP held by households and 80.6% of GDP by non-financial corporations (NFCs) <sup>(17)</sup>. This reflects both the increase in the stock of debt, especially in the case of the corporate sector, and, to a larger extent, the fall in GDP. In both cases, debt ratios are significantly lower than those recorded prior to the global financial crisis, and close or below average euro area levels. According to the Commission estimates, private debt ratios remain above prudential levels and fundamental-based benchmarks.

**15. The reduction of Spain's external net debtor position in terms of GDP came to a halt in the first half of 2020, mainly due to the contraction in GDP.**

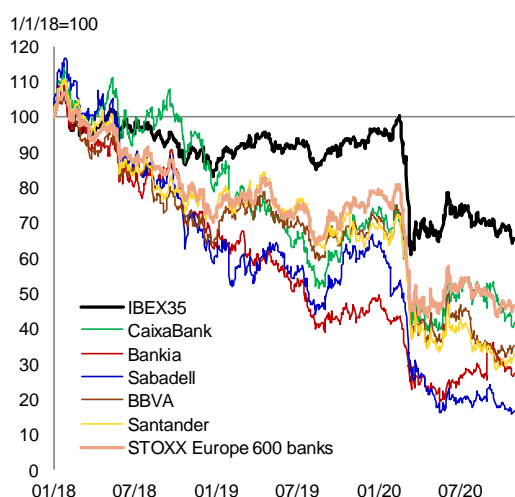
The current account surplus declined to 1.5% of GDP at the end of the first half of 2020. The reduction in GDP has led Spain's net international investment position to increase from 74% of GDP at the end of 2019 to 77.5% of GDP by mid-2020, which remains above prudential and fundamental-based benchmarks. Still, it is around 20 percentage points below the peak reached during the financial crisis.

<sup>(17)</sup> Unconsolidated debt of non-financial corporations amounted to 102.7% of GDP in the second quarter of 2020, and private unconsolidated debt was 163.3% of GDP.

### 3. FINANCIAL SECTOR TRENDS

**16. Thanks to a number of support measures introduced by the authorities, Spain's financial sector remains stable although concerns remain.** Much like those of other EU banks, the share prices of Spanish banks declined quite steeply during March 2020, reflecting weakening economic sentiment amidst the rapid evolution of the pandemic and the introduction of strict containment measures. The market prices have stabilised over the summer (see Graph 3.1). Meanwhile, the drive for consolidation in the banking sector has gained significant momentum, especially following the announcement over a management level agreement for the merger of Bankia and Caixabank in early September 2020 <sup>(18)</sup>.

Graph 3.1: IBEX35, STOXX 600 Banks and selected Spanish banks stocks



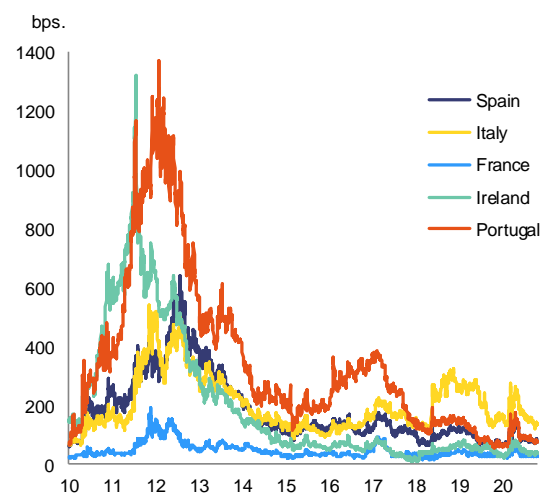
Source: Madrid Stock Exchange via Macrobond, own calculations.

**17. The sovereign debt markets, which have been hit in the early phase of the pandemic, have recovered, (see Graph 3.2).** The spread between Spain's benchmark 10-year government bond and the 10-year German bund reached a peak of 158 bps on 22 April 2020, its highest level for over three years. The spread rates have declined in the following months, backed by a more optimistic outlook, the gradual reversal of containment measures, ECB's asset purchase actions, and the entry into force of government support schemes

<sup>(18)</sup> The merger, which is still subject to both shareholder and supervisory approvals at the writing of this report, is expected to be finalised within the first half of 2021.

(see under Section 4.2). Likewise, the 5-year Spanish CDS spread peaked at 139 basis points on 21 April 2020, the highest level since 2014, but has declined to 55 basis points by mid-September. Despite these positive developments, S&P, while maintaining its rating for Spain at A, revised the outlook to negative in September 2020, citing economic and fiscal challenges amidst potential political fragmentation, while other major rating agencies kept the rating and the outlook stable.

Graph 3.2: Sovereign spreads to the 10-year German bund

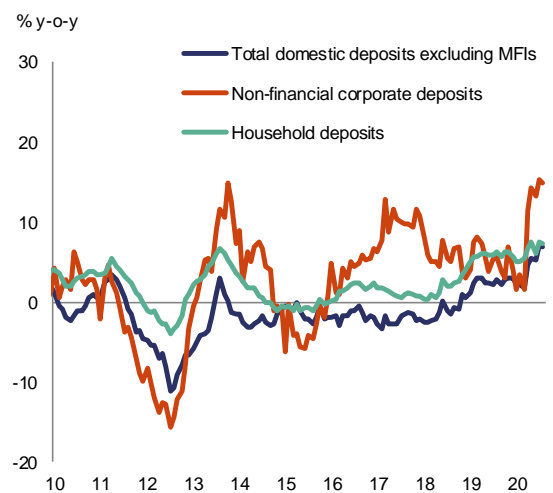


Source: IHS Markit, Macrobond, own calculations.

**18. Liquidity in the Spanish banking sector has reached its highest levels in recent years.** In particular, Spanish banks' total net borrowing from the Eurosystem increased substantially over the summer to reach EUR 257 billion at end-August 2020, up from EUR 133 billion at end-2019. Total domestic bank deposits excluding monetary financial institutions (MFIs) also increased, by 6.9% on a year-on-year basis (y-o-y) in August 2020. Within the private sector deposits, non-financial corporate deposits increased substantially by +15.0% y-o-y while household deposits grew more moderately at +7.2% y-o-y (see Graph 3.3). Meanwhile, the issuance of debt securities, some of which could be used for meeting MREL requirements <sup>(19)</sup>, has slowed down. Most of the covered bond issuances have been retained by banks for potential use in case there is an increased need to obtain market or central bank liquidity.

<sup>(19)</sup> MREL: Minimum Requirement for own funds and Eligible Liabilities.

Graph 3.3: Bank deposits



Source: BdE.

### 19. Increased liquidity levels and government support schemes have reversed the pre-pandemic trend of asset deleveraging in the banking sector, as banks increased lending to the real economy during the pandemic. Between August 2019 and August 2020, banks' domestic assets<sup>(20)</sup> increased by 9.5%, to EUR 2.06 trillion.

Total assets, which also include assets of foreign subsidiaries and branches, rose by 7.1% to EUR 2.89 trillion in the same period. This represents a significant reversal of the asset deleveraging that has been observed since 2012, although deleveraging continued in terms of risk-weighted assets (RWA), which declined by 3.2%. The volume of both debt securities and private sector credit have grown. In particular, the outstanding volume of loans to non-financial corporates (NFCs) has risen substantially by 7.0%, (see Graph 3.4). This development was largely driven by new loans worth EUR 250,000 or more, which grew by 25.1% (y-o-y) in the first eight months of 2020<sup>(21)</sup>. A substantial proportion of these new loans are backed by guarantees of the state-owned development bank, *Instituto de Crédito Oficial* (ICO). The growth in the outstanding loans for households was more modest at 2.2%. Meanwhile, the issuance of new loans for home purchases and consumer credit have both declined in the first eight months of 2020, by 7.6% and 13.9% (y-o-y), respectively. Thus, the growth

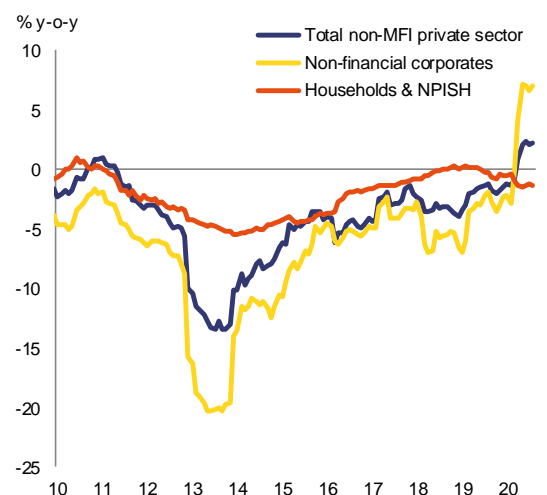
<sup>(20)</sup> Source: BdE,

<https://www.bde.es/webbde/es/estadis/infoest/a0802e.pdf>

<sup>(21)</sup> At the same period, the total volume of new NFC loans that are less than EUR 250,000 decreased by 0.9%.

in the volume of outstanding household loans was not only driven by new lending activity but also by the introduction of moratoria schemes that have postponed loan repayments.

Graph 3.4: Bank loans to the private sector



The decrease in the stock of loans in late 2012 and early 2013 was due to the transfer of assets to SAREB.

Source: BdE, own calculations.

**20. According to ECB's Bank Lending Survey for the third quarter of 2020, credit standards applied by Spanish banks for approving loans have evolved in a contrasting manner<sup>(22)</sup>, and in opposite direction than in the previous quarter.** For enterprise loans, credit standards have considerably tightened, offsetting the easing over the second quarter, with the government credit guarantees allowing banks to maintain standards that are more favourable. After a strong rise in the demand for loans by firms in the second quarter, supported by the relatively high take-up of the ICO guarantees, the most recent quarter has seen a slight contraction. Credit standards for consumer loans and loans for house purchases have tightened further in the third quarter, but to a much lesser extent than over the previous one, resulting in a recovery of demand for consumer and housing loans.

### 21. Since the onset of the pandemic, the pace of NPL reduction has significantly slowed down.

<sup>(22)</sup> According to the Eurosystem Bank Lending Survey of October 2020. See the report at:

[https://www.ecb.europa.eu/stats/ecb\\_surveys/bank\\_lending\\_survey/html/index.en.html](https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/index.en.html)

The total stock of NPLs as reported by the BdE <sup>(23)</sup> in both the corporate and household segments decreased by EUR 5.2 billion (-8.2%) to EUR 57.8 billion by July 2020 compared to twelve months before. Most of this reduction was achieved in the second half of 2019, while as of March, the pace of loan sales and other restructuring activity weakened in amidst the pandemic. However, some activity has resumed recently in this market. The share of NPLs in total loans (NPL ratio) remains at 4.7% as of end-July 2020, only slightly lower than the end-2019 of 4.8%, (see Graph 3.5). The stock of household NPLs, which represent nearly half of the total stock, actually increased in the first half of 2020, with a net inflow of EUR 1.6 billion of NPLs. At consolidated level, data from the European Banking Authority (EBA) shows that the NPL ratio for Spanish banks decreased from 3.5% at end-June 2019 to 3.0% at end-June 2020, which is comparable with the EU average of 2.9%. The EBA data also shows that provisioning levels have remained more or less stable, with total impairments on NPLs representing 43.3% of NPLs at end-June 2020, up from 42.9% a year earlier and below the EU average of 45.3%.

**22. The legislative and non-legislative payment moratoria have given banks and some of the borrowers some breathing space.** According to the latest data from BdE, the total volume of qualifying loans subject to legislative and non-legislative loan moratoria were EUR 23.4 billion and EUR 28.7 billion, respectively, as of end-September 2020. This represents 7.9% of the total credit stock eligible for the moratoria measures and 4.7% of bank credit to the non-financial private sector <sup>(24)</sup>. It is important to note that these measures and the accompanying EBA guidelines have significantly altered the way in which banks categorise risks and provision for expected credit losses <sup>(25)</sup>. Although banks have not yet

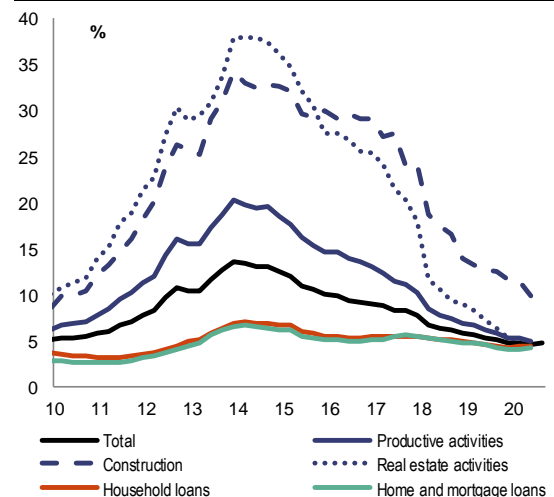
<sup>(23)</sup> The BdE reports the stock of doubtful debtors, to which this report refers as NPLs.

<sup>(24)</sup> The take up of the more recent payment moratoria schemes for the tourism and transport that were introduced in July 2020 remains quite limited, covering a total of EUR 0.6 billion of loans. For more details on the take-up of the various moratoria schemes, see [https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/Briefing\\_notes/en/notabe021020en.pdf](https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/Briefing_notes/en/notabe021020en.pdf).

<sup>(25)</sup> For more, see EBA's guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis, which were introduced on 2

experienced a significant evidence of non-payments following the expiry of the legislative moratoria, it remains to be seen if this will continue following the expiry of most of these schemes in 2021.

Graph 3.5: Ratio of non-performing loans



(1) The scope of non-performing loans covered in these figures overlap with BdE's definition of doubtful loans.  
(2) Home loans comprise also loans that are not mortgages

Source: BdE, own calculations.

**23. The profitability of the banking sector remained under pressure in the first half of 2020, driven by high levels of impairments and one-off impacts in some banks.** At the aggregate level, Spanish credit institutions registered a pre-tax loss of EUR 4.82 billion in the first half of 2020 <sup>(26)</sup>. These losses were largely driven by a significant rise in booking in advance of provisions for future credit losses as well as goodwill deterioration applicable to foreign subsidiaries of BBVA and Santander. Credit provisions resulted in a cumulative impairment of financial assets of around EUR 15.2 billion within the first half of 2020, which is around 100% greater than the level of provisioning a year ago. According to BdE's Financial Stability Report, these losses translated into a steep drop in return on assets (ROA) to -0.5% by June 2020. The return on equity (ROE) also dropped significantly to -7.3%. Excluding one-off impacts, the profitability of the Spanish

April 2020 (EBA/GL/2020/02) and revised on 25 June 2020 (EBA/GL/2020/08).

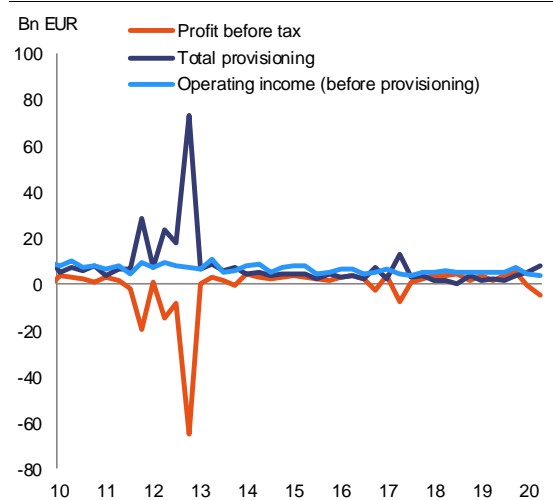
<sup>(26)</sup> Banco de España Financial Stability Report, [https://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinancera/20/fincheros/FSR\\_2020\\_2\\_Ch2.pdf](https://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinancera/20/fincheros/FSR_2020_2_Ch2.pdf)



banking sector declined significantly but remained positive (ROE 2.1% in June).

future evolution of the pandemic and its impact on the Spanish economy.

Graph 3.6: **Bank sector profitability for domestic operations**



Source: BdE, own calculations.

**24. Despite these significant losses <sup>(27)</sup>, thanks to capital relief and public support measures, the capital positions of Spanish banks have slightly improved.** However, they remained relatively low compared to other EU Member states and in a context of considerable uncertainties and risks from the pandemics. According to June 2020 data, the fully-loaded common equity tier 1 (CET 1) ratio for the Spanish banking sector was 12.1%, up from 11.9% a year ago. Banks were able to increase their capital positions partly due to the impact of public guarantee programmes for bank lending on RWAs and the EU’s temporary “quick fix” measure, which was introduced in response to the COVID-19 pandemic <sup>(28)</sup>. It is nevertheless important to note that Spanish banks have the lowest capital ratios within the EU, while there are lingering uncertainties over – and risks from – the

<sup>(27)</sup> It is worth highlighting that, under the current rules for calculating own funds, the entire amount of goodwill is deducted from regulatory capital. Therefore, the adjustments to goodwill that led to these losses have no impact on solvency.

<sup>(28)</sup> [Regulation \(EU\) 2020/873](#) of 24 June 2020 intends to help mitigate impact of the COVID-19 outbreak on financial intermediaries and incentivise the flow of credit to the real economy. More specifically, the regulation defers the application of leverage ratio and introduces flexibility and favourable treatment of certain types of risks (eg. exposures to SMEs, public debt).

## 4. FINANCIAL SECTOR REFORMS AND POLICY

### 4.1. MEASURES TO MITIGATE THE IMPACT OF THE PANDEMIC ON THE BANKING SECTOR

**25. Spanish authorities and the banking sector have implemented a number of measures to provide support to the most affected businesses and households.**

**26. The legislative and non-legislative payment moratoria have been key to providing a temporary breathing space for borrowers and their banks.** The legislative moratoria, which were introduced in March 2020, allowed a deferral of all payment obligations arising from household mortgage loans that are backed by primary residences<sup>(29)</sup> and non-mortgage loans for economically vulnerable individuals for up to three months. The legislative moratoria expired at end-September 2020. In May 2020, a special system for non-legislative moratoria was introduced, providing deferrals for all employees and self-employed persons, broadening the eligibility criteria and extending the overall deferral period (i.e. up to 12 months for mortgage loans and 6 months for non-mortgage loans). Unlike the public moratoria, the banking sector moratoria defer only the contractual principal payments and not the interest payments. Lastly, two new moratoria have been introduced in July 2020, applicable to all natural persons working in the tourism sector and entities active in the transportation of goods and transport of passengers by bus.

**27. Publicly guaranteed credit lines have also been implemented to provide liquidity to affected non-financial corporations.** Among the measures taken to respond to the economic crisis caused by the coronavirus pandemic, the state-owned development bank, *Instituto de Crédito Oficial* (ICO), operates the largest guarantee credit lines in collaboration with financial institutions. There are two main programmes. The first one aims at granting financing to companies and individual entrepreneurs by guaranteeing liquidity and covering the working capital needs of the self-

employed, SMEs and other companies, in order to maintain productive activity and employment. The total envelope of guarantees foreseen amounts to EUR 100 billion. According to ICO, as of 30 September, this programme has supported 823,847 operations corresponding to more than 541,000 companies, with 88% of them being self-employed or micro enterprises. The total guaranteed amount is EUR 77.7 billion. This has allowed companies to receive more than EUR 102 billion of financing to cover their liquidity and their working capital needs. According to the BdE, the information on bank lending shows that firms are resorting to this source of financing to cover a sizeable portion of their liquidity needs. In fact, of the EUR 174 billion lent to non-financial corporations from December 2019 to June 2020 via new lending business, EUR 71.5 billion (41%) corresponded to ICO guaranteed loans. In addition, another guarantee line of EUR 40 billion aims at guaranteeing the financing granted to companies and self-employed to cover mainly their financial needs derived from the realization of new investments. Going forward, in order to address the emerging problems as regards the viability and solvency of the corporate sector, current temporary measures, though very effective in the short term, will have to be complemented with more structural measures. In this context, effective debt resolution and restructuring frameworks for the corporate sector will play a key role. Any measures to strengthen these will improve not only the functioning of the corporate sector, but also reduce the risk of overly large volumes of NPLs accumulating on banks' balance sheets.

### 4.2. PROGRESS WITH FINANCIAL SECTOR REFORMS AND CHALLENGES AHEAD

**28. Banking consolidation continues.** Lower profitability and a supportive stance from the Single Supervisory Mechanism (SSM) have been a driver for recent developments. On 17 September 2020, Caixabank and Bankia's boards of directors endorsed a merger project. Both institutions have highlighted the operation's strategic rationale, which is to lower costs and improve efficiency. The merger will bring about the largest credit institution in Spain with a 25% market share in terms of loans and 24% of deposits. The

<sup>(29)</sup> The legislative moratoria are also applicable to cover properties used for economic activity by self-employed persons as well as owners of rental property who have ceased to receive rent payments by application of the moratorium on rent payments.

combination will be an all-share deal, to be approved by the two shareholder meetings.

**29. A key role in this possible merger is played by the FROB** <sup>(30)</sup>. Once Bankia's Extraordinary Shareholder Meeting is called to decide on the deal, BFA (the holding through which FROB invests in Bankia) would cast its vote, as the direct shareholder. FROB's Governing Committee would instruct BFA on the vote, based on the value optimisation *vis-à-vis* future divestment processes. It is expected that FROB's strategy continues to be guided by balancing between the government's objective of disposing its controlling stake in Bankia while maximising the recovery of public funds. If the merger goes ahead, FROB will be the second largest shareholder in the combined entity with a share of 16.1%. Further consolidation might take place, according to market participants, and two banks (Liberbank and Unicaja) have confirmed that they are analysing a possible merger.

**30. Resolution planning is proceeding well.** The Single Resolution Board has drafted resolution plans for all Spanish significant institutions and the Bank of Spain aims to have 100% of the Less Significant Institutions covered by resolution plans by the end of the 2020 cycle. MREL targets for all Spanish banks will be notified in the first months of 2021. Most credit institutions do not foresee significant difficulties in complying with their MREL targets, taking into account the transition periods set by the authorities under the first version of the Bank Recovery and Resolution Directive, and the revised targets that will follow its revision.

#### 4.3. SAREB – RECENT DEVELOPMENTS AND OUTLOOK

**31. At the mid-point of its expected lifetime, SAREB** <sup>(31)</sup> **has sold 36% of its assets and**

<sup>(30)</sup> *Fondo de Reestructuración Ordenada Bancaria* (FROB) was created in 2009 to provide public support for the consolidation of the Spanish banking sector by, inter alia, strengthening the capital buffers of credit institutions.

<sup>(31)</sup> SAREB (Sociedad de gestión de Activos procedentes de la Reestructuración Bancaria) is an asset management company that was created to divest the assets transferred from the old savings banks and help the economy recover. 54% of its share capital is owned by private shareholders, but the main shareholder (46%) is the public Fund for Orderly Bank Restructuring (FROB).

**redeemed 31% of its senior debt.** SAREB's senior debt, which enjoys a state guarantee and is held by the banks that had received state aid, was reduced from EUR 50.8 billion to EUR 35.1 billion by 30 June 2020.

**32. SAREB has been implementing a new strategy since 2019 and has been able to slowly convert its RED (real estate development loans) into assets.** The new strategy is to rely less on non-performing loans sales, in the light of the high discounts demanded on that market. In turn, SAREB aims to intensify its efforts on converting loans into the underlying collateral, which can then be marketed and sold in the retail property market. As a result, 2019 is the first year in which real estate has been the main source of revenues versus income from financial assets. In addition, SAREB has implemented several measures to streamline its expenditures in an attempt to control and monitor its assets more directly and to decrease unnecessary servicing fees. As of June 2020, 56% of the total balance sheet of SAREB comprises of loans and advances, which are almost entirely NPLs. The remaining part of SAREB's balance sheet comprises of over EUR 14 billion REO (real estate owned). Nearly 20% of these properties are published for retail sales, while the rest either is not published or targeted for specialised sales.

**33. Sustained losses have eroded SAREB's capital base. Some relief measures have come from the regulatory front.** SAREB has registered losses throughout its lifetime, amounting to EUR 947 million in 2019 and EUR 396 million in the first half of 2020. Moreover, the RED and the REO portfolios include significant unrealized losses. A number of relief measures have been adopted. Real Decreto-Ley 4/2006 allowed SAREB to account for asset impairments against valuation adjustments without registering them under its profit and loss accounts. At the end of June 2020, these valuation adjustments amounted to EUR 7,431 million, to which EUR 769 million of a negative adjustment from an IRS swap are added. More recently, Real Decreto-Ley 6/2020 <sup>(32)</sup> waives SAREB from compulsory winding-up when its equity falls below half of its share capital. In order to strengthen its capital,

<sup>(32)</sup> *Real Decreto-ley 6/2020*, de 10 de marzo, por el que se adoptan determinadas medidas urgentes en el ámbito económico y para la protección de la salud pública.

SAREB converted part of its subordinated debt into equity in 2016. The ongoing pandemic crisis could put additional strain on the real estate market and, thereby, on SAREB's operations. Therefore, stakeholders may be forced to reconsider SAREB's role and strategy in 2021.

# ANNEX A

## Main macroeconomic and financial indicators

Table A.1: **Main macroeconomic and financial indicators**

	2000 -2007	2008 -2013	2014	2015	2016	2017	2018	2019	2020 (f)	2021 (f)
<b>Core indicators</b>										
GDP growth rate	3.7	-1.3	1.4	3.8	3.0	3.0	2.4	2.0	-12.4	5.4
of which domestic demand incl. stocks	4.5	-3.1	1.9	3.9	2.0	3.1	3.0	1.4	-10.7	3.7
Private consumption (annual % change)	3.7	-2.1	1.7	2.9	2.7	3.0	1.8	0.9	-14.6	4.5
Public consumption (annual % change)	5.0	0.9	-0.7	2.0	1.0	1.0	2.6	2.3	6.0	2.1
HICP (annual % change)	3.2	2.2	-0.2	-0.6	-0.3	2.0	1.7	0.8	-0.2	0.9
Unemployment rate (% of labour force)	10.6	20.2	24.5	22.1	19.6	17.2	15.3	14.1	16.7	17.9
Gross fixed capital formation (% of GDP)	27.7	21.4	17.8	18.0	18.0	18.7	19.5	19.9	18.5	18.2
Gross national saving (% of GDP)	22.3	18.8	19.6	21.0	21.9	22.2	22.4	22.9	21.3	21.6
<b>General Government (% of GDP)</b>										
Balance (g)	0.4	-8.8	-5.9	-5.2	-4.3	-3.0	-2.5	-2.9	-12.2	-9.6
Gross debt	46.7	67.6	100.7	99.3	99.2	98.6	97.4	95.5	120.3	122.0
Interest expenditure	2.2	2.4	3.4	3.0	2.8	2.5	2.4	2.3	2.4	2.2
<b>Households</b>										
Households saving rate	8.9	8.9	6.3	7.2	7.1	5.8	5.6	6.3	18.2	15.3
<b>Rest of the world (% of GDP)</b>										
Trade balance	-3.7	-0.1	3.1	3.0	4.0	3.6	2.7	3.0	1.9	3.3
Trade balance, goods	-6.8	-4.1	-2.1	-1.9	-1.3	-1.9	-2.5	-2.1	-0.2	-0.1
Trade balance, services	3.1	4.0	5.2	5.0	5.3	5.5	5.2	5.1	2.1	3.4
Current account balance	-5.9	-2.9	1.7	2.0	3.2	2.8	1.9	2.1	1.8	2.5
Net financial assets	-55.3	-90.4	-95.2	-88.2	-84.7	-84.9	-79.4	-73.3		
Net international investment position (h)	-56.5	-91.6	-95.9	-88.9	-85.5	-84.9	-79.2	-73.9		
<b>Competitiveness (index, 2015=100)</b>										
Real effective exchange rate relative to the rest of the euro area	104.5	107.9	100.4	100.0	98.3	98.1	97.2	97.8	99.6	98.3
Real effective exchange rate relative to the rest of the European Union	104.7	107.6	100.3	100.0	98.2	97.6	96.7	97.2	99.1	97.9
Real effective exchange rate relative to the rest of 37 industrialised countries	104.3	111.6	104.1	100.0	99.0	99.8	100.4	n.a.	n.a.	n.a.
<b>Banking sector</b>										
Assets (% of GDP)	214.9	325.0	288.0	262.5	244.9	234.4	219.7	215.1		
Private domestic credit (y-o-y %)	17.8	-3.0	-6.5	-4.2	-4.1	-2.0	-3.9	-1.5		
Non-performing loans (NPLs), total (%) (i)	1.0	7.7	12.5	10.1	9.1	7.8	5.8	4.8		
NPLs, productive activities (%)	1.0	10.8	18.5	14.6	13.1	10.3	6.9	5.4		
" of which, construction, and (%)	0.9	17.3	32.6	30.0	29.1	24.1	14.0	11.7		
" real estate activities (%)	0.5	19.8	36.2	27.5	25.5	18.1	9.0	5.2		
NPLs, residential mortgages (%)	0.4	3.7	6.3	5.1	5.2	5.6	4.9	4.1		
<b>ECB ratios (%) (j)</b>										
NPL (domestic and controlled foreign branches and banks)	n.a.	n.a.	8.1	6.3	5.7	4.4	3.7	3.1	3.0	
" of which non-financial corporations	n.a.	n.a.	16.4	12.8	10.9	7.9	5.9	4.7	4.4	
" of which households	n.a.	n.a.	5.3	4.5	4.5	4.4	4.0	3.6	3.7	
Coverage	n.a.	61.7	46.4	46.8	45.0	42.7	43.7	43.8	44.1	
Return on equity (k)	n.a.	1.8	6.7	6.6	5.0	7.0	8.2	6.8	-0.1	
Return on assets (k)	n.a.	0.1	0.5	0.5	0.4	0.5	0.6	0.5	0.0	
Total capital	n.a.	12.1	13.6	14.5	14.7	15.4	15.4	15.7	15.5	
CET 1	n.a.	n.a.	11.8	12.7	12.8	12.6	12.2	12.5	12.1	
Tier 1	n.a.	9.8	11.8	12.7	13.0	13.2	13.5	13.8	13.4	
Loan-to-deposit	n.a.	n.a.	90.3	91.7	92.5	89.3	90.6	92.6	91.1	
<b>Interest rates</b>										
10 year spread vis-à-vis the Bund (%)	0.1	2.1	1.5	1.2	1.3	1.2	0.9	0.9		
CDS 5 year (basis points)	n.a.	221.5	90.5	84.1	82.1	67.4	62.6	52.0		

Updated on 30 Oct 2020

(f) forecast

(g) General government balances include capital transfers related to support of banks

(h) ESA2010 and BPM6, latest quarter divided by a 4 quarters rolling GDP

(i) NPLs: ratios, in % of total loans, end-of-period, source: BdE

(j) ECB ratios, end-of-period, 2020q1

(k) annualised

**Source:** Ameco, BdE, Boursorama, ECB, Eurostat, Macrobond.









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