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Post-Programme Surveillance Report

Spain, Autumn 2018

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European Commission
Directorate-General for Economic and Financial Affairs

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Spain, Autumn 2018

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Institutional Paper 091

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ABBREVIATIONS

ANESFI	Autoridad Nacional de Estabilidad Financiera, National Financial Stability Authority
BdE	Banco de España, Bank of Spain
BMN	Banco Mare Nostrum, S.A.
BRRD	Bank Recovery and Resolution Directive
CCyB	Counter-Cyclical capital Buffer
CDS	Credit Default Swaps
CESFI	Consejo de Estabilidad Financiera, Financial Stability Committee
CET 1	Common Equity Tier 1
CNMV	Comisión Nacional del Mercado de Valores, National Securities Market Commission
CSRs	Country-Specific Recommendations
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ESM	European Stability Mechanism
EU	European Union
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
IBEX 35	Spanish stock maket index benchmark
INE	Instituto Nacional de Estadística, the Spanish National Statistics Institute
MREL	Minimum Requirement for own funds and Eligible Liabilities
NFCs	Non-Financial Corporations
NPLs	Non-Performing Loans
PPS	Post Programme Surveillance
REOs	Real Estate Owned assets
ROE	Return on Equity
SAFE	Survey on the Access to Finance of small and medium-sized Enterprises
SAREB	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A.
SMEs	Small and Medium-sized Enterprise
SRB	Single Resolution Board
y-o-y	year on year

EXECUTIVE SUMMARY

This tenth surveillance report provides an assessment of Spain's economic and financial situation following its exit from the financial assistance programme in January 2014. A team from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), carried out the tenth post-programme surveillance visit to Spain on 4-5 October 2018 ([1]). The European Stability Mechanism (ESM) participated in the meetings in the context of its own Early Warning System. The report focuses on macroeconomic and financial sector developments over the past months, complementing the surveillance by the Commission under the macroeconomic imbalances procedure, the Stability and Growth Pact and, more broadly, the European Semester of economic policy coordination.

The Spanish banking sector continues to enjoy overall comfortable solvency and liquidity. Its profitability has also improved, mainly thanks to the decline of loan-loss provisions related to the reduction in non-performing loans. The non-performing loans ratio for the Spanish banks, including on their international activity, has continued to decline to just above the EU average. The implementation of the January 2018 merger of BMN with Bankia has progressed well. Completing the privatisation of Bankia and the further divestment of banking foundations in savings banks will continue to reinforce the Spanish banking sector. Finally, the asset management company SAREB, which recorded again negative financial results, is preparing a new management strategy for its assets and is assessing how this might improve its profitability and effectiveness.

Strong and balanced growth, accompanied by dynamic job creation, supports the correction of macroeconomic imbalances, but challenges remain. The Commission 2018 autumn forecast projects growth to moderate, from 2.6% this year to 2.2% in 2019 and 2.0% in 2020, but remain above the EU and euro area average over the forecast horizon. Job creation is also expected to moderate, though unemployment will continue to decline. Decreasing but still high external and domestic debt levels and unemployment warrant policy efforts to ensure a more durable growth path and achieve higher productivity growth. In line with the country-specific recommendations issued by the Council of the European Union on 13 July, these should include steps to continue reducing unemployment, make the labour market more inclusive, improve the business environment and enhance the innovation capacity of the economy. At the same time, Spain should pursue fiscal consolidation with a view to ensuring a decisive reduction of its high government debt ratio and re-building the fiscal buffers needed to overcome any possible adverse shocks, while preserving the long-term sustainability of its public finances.

On the basis of the analysis in the report, repayment risks for the ESM loan appear very low. Overall, a more stable financial sector and the strong economic recovery keep repayment risks low. The government's debt issuance continues to decline and, despite volatility in the financial market caused by external factors, the average cost of outstanding debt in October 2018 was about 1.6 pp lower than in 2011, while the cost of issuance remains very low. This, combined with a lengthening average life of debt outstanding, further decreases repayment risks for the ESM. On 20 September 2018, the Board of Directors of the European Stability Mechanism (ESM) approved an additional voluntary repayment of EUR 3 billion, bringing the total amount of voluntary early repayments in 2018 to EUR 8 billion. Following this, the outstanding amount of the ESM loan stands at EUR 23.7 billion.

The next post-programme surveillance mission will take place in spring 2019.

([1]) 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.

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(2) 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 under State-aid rules, and around EUR 2.2 billion for capitalising SAREB, the Spanish asset management company. Both the bank-specific conditionality and the horizontal conditionality included in the Memorandum of Understanding were fulfilled as scheduled.(3) From July 2014 to May 2018, Spain made eight voluntary early repayments. On 20 September 2018, the Board of Directors of the European Stability Mechanism (ESM) approved an additional voluntary repayment of EUR 3 billion. Following this, the outstanding amount of the ESM loan stands at EUR 23.7 billion.

2. Staff from the European Commission, in liaison with the European Central Bank, undertook the tenth post-programme review mission to Spain from 4 to 5 October 2018. The ESM participated in the meetings on aspects related to its own Early Warning System. Post-programme surveillance (PPS) aims at a broad monitoring of the repayment capacity of a country having received financial assistance.(4) There is no policy conditionality under PPS, although the Council can issue recommendations for corrective actions if deemed necessary and appropriate. PPS is biannual in terms of reporting and missions. The previous PPS mission took place in April 2018.(5)

(2) 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.

(3) For more details see the report: https://ec.europa.eu/info/publications/economy-finance/evaluation-financial-sector-assistance-programme-spain-2012-2014_en.

(4) 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.

(5) For more details see the night PPS report: https://ec.europa.eu/info/publications/economy-finance/post-programme-surveillance-report-spain-spring-2018_en.

3. The autumn 2018 PPS focuses on the Spanish financial sector, complementing the surveillance under the macroeconomic imbalances procedure, the Stability and Growth Pact and more broadly the European Semester of economic policy coordination. This PPS report complements the 2018 Country Report for Spain(6), published on 7 March 2018 in the context of the European Semester. That report included an In-Depth Review on the prevention and correction of macroeconomic imbalances under Article 5 of Regulation (EU) No 1176/2011. The Commission's analysis in the report led it to conclude that Spain is experiencing macroeconomic imbalances which have cross-border relevance(7). On 13 July 2018, the Council of the European Union adopted the 2018 Country-specific Recommendations (CSRs), which called on Spain(8) to pursue structural reforms in the areas of the labour market, social policy, education, business regulation, and research and innovation. The Council also called on Spain to ensure compliance with the Council decision of 8 August 2016 giving notice under the excessive deficit procedure of the Stability and Growth Pact(9) and set out the fiscal adjustment path for 2019, when Spain is expected to enter the preventive arm of the Pact. The responsibility for implementing the CSRs lies with the new government that was formed on 7 June 2018.

(6) https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-spain-en.pdf

(7) https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-communication_en.pdf.

(8) https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-specific-recommendation-commission-recommendation-spain-en.pdf.

(9) http://data.consilium.europa.eu/doc/document/ST-11552-2016-INIT/en/pdf.

2. MACROECONOMIC DEVELOPMENTS

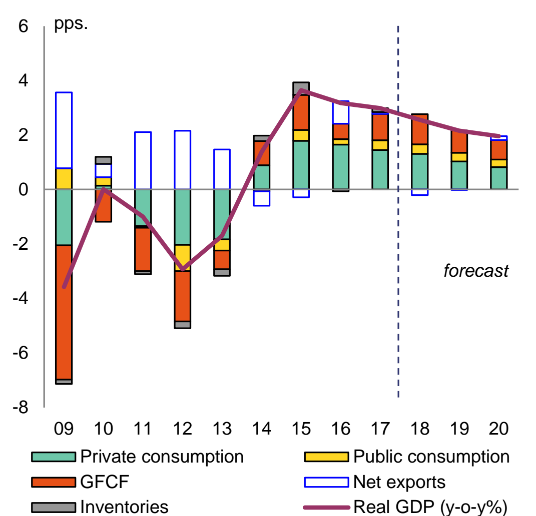
4. Spain has continued to record robust growth. After expanding by a robust 3.0% in 2017, real GDP growth stood at 0.6% q-o-q in the first three quarters of 2018. During this period, private consumption remained robust, and investment, especially in equipment, surprised by its strength. However, net exports have evolved worse than anticipated, and had a negative contribution to growth.(10) According to the European Commission 2018 autumn forecast, growth in 2018 as a whole is expected to reach an annual average of 2.6%, well above the European Union average.(11)

5. Economic activity is expected to moderate in 2019 and 2020, driven by a slowdown in private consumption. Growth is expected to decelerate to 2.2 % in 2019 and 2.0% in 2020. The deceleration is mainly driven by a slowdown in private consumption, as oil prices increase further and pent-up demand is absorbed. However, still robust job expansion and accelerating wage growth – also due to the planned increase in the minimum wage - should continue to support disposable income growth over the forecast horizon. As a result, the saving rate, which is expected to reach a historic low in 2018, is projected to rebound in 2019 and increase slightly further in 2020. Investment is also expected to moderate in 2019 and 2020 but continue growing above final demand, both in equipment and construction, especially residential construction.

6. The contribution of the external sector to growth is expected to become positive again. Exports are expected to accelerate in 2019 and then stabilise, as export markets recover, cost-competitiveness gains continue, and the impact of the appreciation of the euro fades away. After growing more strongly than expected in 2017, imports are set to slow over the forecast horizon as final demand moderates. As a consequence, after being negative in 2018, the contribution of net exports to growth is expected to turn positive again in 2019. The terms of trade are forecast to deteriorate further in 2018 and then become broadly neutral. These factors should result in a decline of the current account surplus in 2018 and 2019, before improving slightly in 2020.

7. Risks to the outlook are tilted to the downside. Most downside risks identified in the first half of the year have materialised, translating in lower than expected growth in recent quarters. Risks to growth include lower than expected global (and EU) growth, protectionism and trade tensions, higher than anticipated oil prices and EUR exchange rates, domestic and external political uncertainty, monetary policy, and uncertainty regarding the macroeconomic impact of certain policy measures, such as the proposed increase in the minimum wage.

Graph 2.1: Composition of GDP growth



GFCF: gross fixed capital formation
Source: INE, European Commission Economic Forecast, autumn 2018

8. Core inflation is expected to gradually increase, as wage growth increases and the output gap, expected to turn positive this year, widens. The European Commission 2018 autumn forecast projects HICP inflation to decline from 1.8% in 2018, to 1.7% in 2019 and 1.5% in 2020, as the pickup in core inflation is offset by base effects from oil price developments.

9. Unemployment is set to continue falling, despite a deceleration in job creation. Employment growth is expected to slow down over the forecast horizon, as a consequence of the deceleration of final demand, as well as the dampening impact of the planned increase in the

(10) Based on the estimate of the flash GDP and components released on 31 October, 2018.

(11) The European Commission autumn 2018 has a cut-off date of 22 October, and only includes data released until that date.

minimum wage in 2019. Still, unemployment is set to continue falling, to 13.4% in 2020, its lowest level since 2008. Wage growth is expected to peak in 2019, also under the impact of the increase of the minimum wage, and moderate but still grow at a rate above inflation in 2020. As labour productivity is forecast to grow moderately over the forecast horizon, this will lead to increases in nominal unit labour costs.

10. The ongoing recovery of the housing market supports progress in cleaning up banks' legacy assets. After the sharp adjustment that followed the crisis, the housing market and construction sector are recovering. Unsubsidised house prices increased by 6.8% year-on-year in the second quarter of 2018. ([12]) Prices of new dwellings went up by 5.7% and those of used dwellings by 7.0%. House price developments vary greatly across regions, with larger increases in areas where the stock of unsold houses is lower. Moreover, in 2018-Q2, the number of transactions on dwellings increased by 10.3% year-on-year, according to INE. Nevertheless, despite the rise in transactions, in 2018-Q2 residential investment was still at less than half the volume of its pre-crisis peak.

11. The general government deficit is expected to continue narrowing, thanks to continued economic growth and the net impact of budgetary measures included in the 2019 Draft Budgetary Plan. After decreasing by 1.4 pps. to 3.1% of GDP in 2017, the general government deficit is expected to decline further to reach 2.7% of GDP in 2018, thanks to still robust economic growth. The somewhat slower pace of deficit reduction is due to measures included in the 2018 budget law, namely the higher revaluation of pensions, the pay hike for public employees and, to a lesser extent, the tax cut for low-income earners. The headline deficit is set to decline further in 2019, to 2.1% of GDP, on the back of continued firm economic growth and the net impact of measures in the 2019 Draft Budgetary Plan. The latter include higher revenues from environmental taxes and corporate and household income taxes, as well as new taxes on digital services and financial transactions. Higher expenditure on items such as pensions, long-term care and paternity leave are also included and partly offset the impact of revenue-raising measures. In 2020, at unchanged policies, the deficit is expected to narrow to 1.9% of GDP.

12. The public debt ratio is set to continue slowly decreasing but to remain high over the forecast horizon. According to the Commission 2018 autumn forecast, gross general government debt will decrease from 98.1% in 2017 to 95.4% of GDP in 2020, as strong nominal GDP and a primary balance, that is projected to turn into a small surplus in 2019, more than offset the impact of interest expenditure. The average life of debt outstanding as of 3 October 2018 has climbed to around 7.5 years, compared to the low point of 6.2 years in 2013, as the Spanish Treasury has benefitted from lower interest rates to extend maturities. While the cost at issuance had risen slightly from a low of 0.61% in 2016 to 0.78% by 3 October 2018, it remains significantly below the cost of debt outstanding, which stood at 2.45% on that same date. In 2011, both stood at around 4.0%. This implies that the average cost of debt will continue falling for as long as the cost of issuance remains below the cost of debt outstanding. Over the last three years, Spanish banks have reduced their holdings of Spanish government debt instruments and now hold about 17% of total outstanding debt instruments of the state. This is less than the Bank of Spain, which has seen a four-fold increase in its share, from around 5% to more than 22%, mainly in the context of the implementation of the ECB monetary policy decisions. The share of non-resident investors has been rather stable at around 45%.

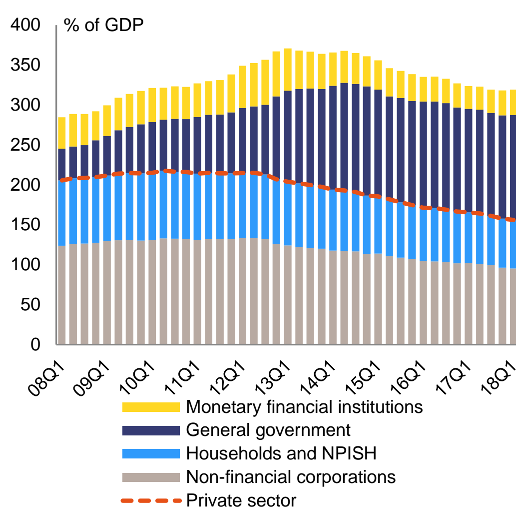
13. The stock of private debt has continued declining, but deleveraging needs persist. The total stock of debt of the non-financial private sector amounted to 156.6% of GDP in non-consolidated terms in the second quarter of 2018 (60.8% of GDP by households and 95.8% of GDP by non-financial corporations (NFCs)) (see Graph 2.2). This is 62.4% of GDP lower than its peak in the second quarter of 2010. ([13]) Although most of the debt reduction is attributable to non-

([12]) Source: INE; other data sources present different results, but all show price increases.

([13]) In consolidated terms, the NFC debt decreased from 118.9% in Q2-2010, including derivatives, to 76.2% in 2018-Q2. Financial derivatives are excluded from these figures.

financial corporations, progress in households' deleveraging was also remarkable. In the second quarter of 2018, the pace of debt reduction slowed down in the case of NFCs, while the total stock of debt actually increased for households in June 2018 for the first time since 2010. The significant growth in new credit to finance durable consumer spending, as well as the reduction in the volume of repayments of mortgages explain the modest increase in the outstanding volume of households' loans. Although the growth in the consumer credit market has supported private consumption in recent years, its rapid increase makes agents more vulnerable to adverse shocks. By contrast, and despite the increase in new credit to NFCs, the total stock of lending by resident institutions to the corporate sector continued declining, in a context of a rise in the issuance of debt securities. GDP growth has thus become the main driver of private sector deleveraging. Despite its reduction, the outstanding stock of private debt remains above prudential levels and fundamental-based benchmarks for both households and NFCs (2018 Country Report for Spain), suggesting that deleveraging needs persist. This is the case in particular for some over-indebted households (such as low-income or jobless households) and for companies that are particularly vulnerable to changes in the economic and financial situation.

Graph 2.2: Indebtedness by sector

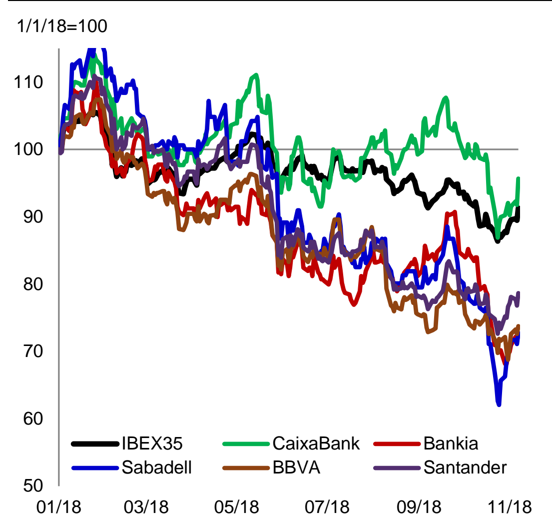


NPISH: Non-profit institutions serving households
Source: BdE, own calculations.

3. FINANCIAL SECTOR TRENDS

14. Spain's financial sector proved resilient in the first three quarters of 2018. The appointment of the new minority government in June has had no visible effect on financial markets and financial stability. Likewise, increased market tensions in Italy have not had any notable impact on the Spanish financial markets. Nevertheless, some Spanish banks exposed to Turkey and Argentina saw their stock prices decrease slightly in 2018-Q3 as a result of economic downturns in these emerging economies. Despite these minor incidents, between January and October 2018 the share prices of Spanish banks broadly followed the IBEX 35 trend ([14]). (Graph 3.1).

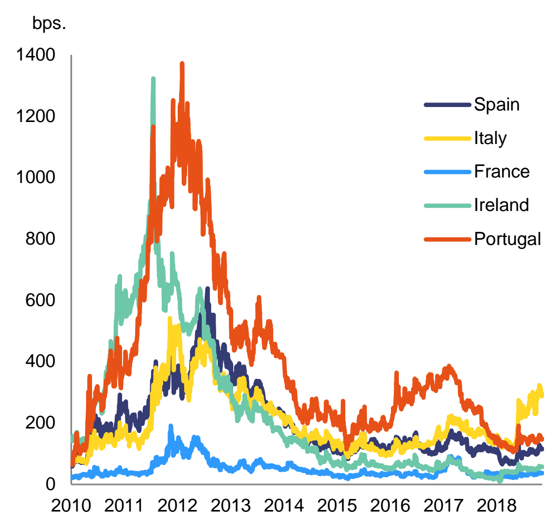
Graph 3.1: IBEX35 and selected Spanish banks stocks



Source: Madrid Stock Exchange via Macrobond, own calculations.

15. Spanish government bond yields and spreads have shown an upward trend since March 2018 (see Graph 3.2). The sovereign spread to the 10-year German bund increased on average by about 35 bps between spring and autumn 2018, to around 120 bps at the end of October, which is however only slightly higher than at the beginning of 2018 (114 bps). It began to increase in mid-May and peaked temporarily at 140 bps at end May, coinciding with the formation of a new Government in Italy and the government no-confidence vote in the Spanish Parliament. This surge was short-lived, with the spread dropping below 90 bps before mid-June. It experienced another temporary and limited increase in September following tensions on the Italian sovereign market. Likewise, the 5-year Spanish CDS spread increased from around 45 basis points in 2018-Q1 to more than 90 basis points at the end of May. It then quickly recovered and stabilised at around 65 basis points in Q3 up until the beginning of September when it fell to below 60 basis points.

Graph 3.2: Euro area sovereign spreads to the 10-year German bund



Source: IHS Markit, Macrobond, own calculations.

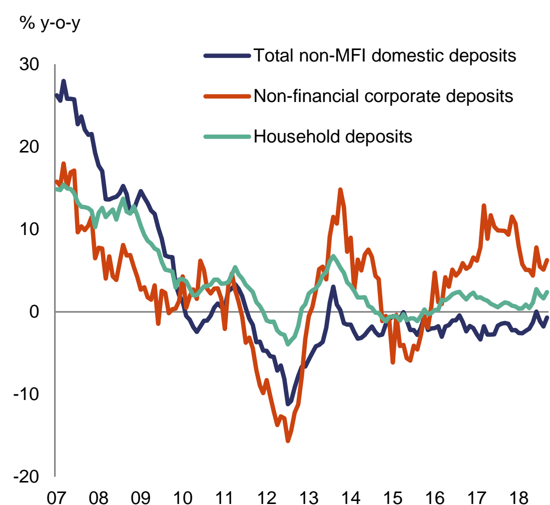
16. Spanish banks continued to diversify their funding sources, away from domestic bank deposits and towards securities. Bank deposits by the private non-financial sector maintained a steady growth pace. In August 2018, deposits of households grew by around 2% y-o-y, while deposits of non-financial corporations grew by more than 5% y-o-y (see Graph 3.3). At the same time, the reduction of bank deposits of non-monetary financial institutions accelerated at a double-digit rate of 19%. Overall, total private domestic bank deposits were declining at an annual rate of around 1.5% in August 2018. In the context of ample liquidity available at favourable costs, the issuance of securities other than shares by credit institutions grew by almost 18% y-o-y in August 2018. In particular, the issuance of non-preferred debt instruments intensified, spurred by the upcoming MREL requirements ([15]). Finally, Spanish banks' total net borrowing from the Eurosystem has remained relatively stable in the

([14]) IBEX 35: Spanish stock maket index benchmark

([15]) MREL: Minimum Requirement for own funds and Eligible Liabilities.

last months, at EUR 168 billion in September 2018.

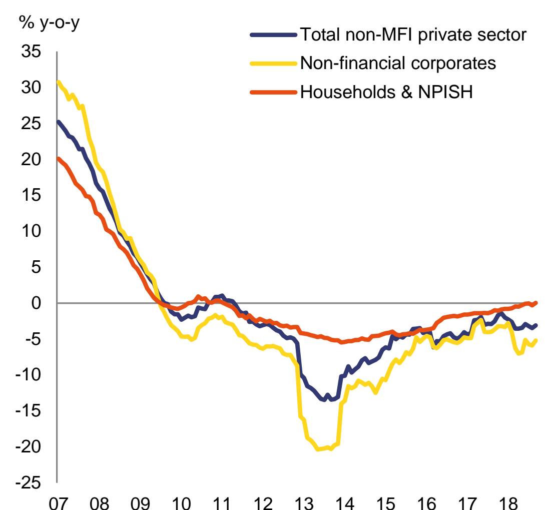
Graph 3.3: Bank deposits



Source: BdE.

17. Banks' assets were slightly lower in the first three quarters of 2018 compared to 2017. In September 2018, banks' domestic assets decreased by less than 2% relative to September 2017, mostly as a result of the decline in the holdings of securities. In the same period, the stock of domestic private credit marginally dropped. The pace of decline in the stock of credit to NFCs accelerated to almost 6% y-o-y as of September 2018 due to growing redemptions and the sale of non-performing loans (NPL) portfolios (see Graph 3.4). New corporate credit has been on the rise: new lending to SMEs (proxied by loans under EUR 1 million) increased by almost 3.8% y-o-y in the three months ended in August 2018, whereas the volume of new loans over EUR 1 million rose by 4.1% in the same period. Also the issuance of debt securities by NFCs picked up by around 6% in August 2018 from a year before. The stock of credit to households has interrupted the downward trend, as the stock of mortgage loans declined by around 1.5% y-o-y in September 2018 while the stock of consumer credit increased by more than 13% y-o-y. New loans for house purchases and consumer credit continued increasing by respectively 3.2% and 25% y-o-y in August 2018.

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.

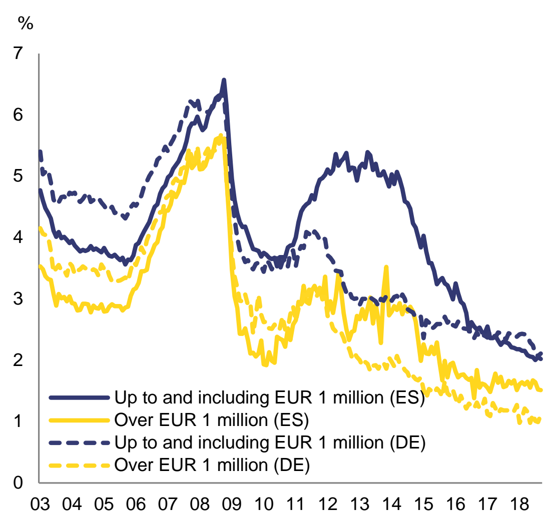
18. In the third quarter of 2018, credit standards for approving loans to NFCs and consumer loans were eased, while remaining stable for housing loans. According to the Eurosystem Bank Lending Survey([16]) of October 2018, there was a moderate easing of credit standards for loans to large companies, while no significant changes were observed for loans to SMEs. The overall terms and conditions on new credit were eased across all firm sizes. The demand for new loans decreased in 2018-Q3 due to a greater recourse to internal funding, as well as lower capital investment needs. Concerning households, credit standards for consumer credit continued easing, in a context of large demand and increased competitive pressures. By contrast, credit conditions for loans to purchase a house remained unchanged in 2018-Q3.

19. Access to finance and availability of bank credit is not considered a problem by Spanish SMEs. This is in line with developments elsewhere in the euro area. In the latest SAFE survey([17]) (October 2017 – March 2018), only 8% of euro area SMEs considered access to finance as the most pressing problem, broadly the same share

([16]) See the report at: http://www.bde.es/webbde/en/estadis/infoest/epb.html
([17]) Survey on the access to finance of small and medium-sized enterprise in the Euro Area at: https://www.ecb.europa.eu/press/pr/date/2018/html/ecb.pr180604.en.html

as in the previous survey. In Spain, this share is also 8%, up from 7% in mid-2017 and down from above 34% in December 2009. The share of Spanish SMEs signalling a further improvement in the availability of bank loans slightly increased from 23% to 24% between H1 and H2 2017, and it remained the highest in the euro area. In parallel, the average interest rate for new loans to NFCs of up to EUR 1 million (a proxy for SME financing cost) dropped in March 2018 by a further 5 bps from end-2017, to 2.15%, which is almost 30 bps lower than the interest rate charged in the same period in Germany (2.42 %).

Graph 3.5: Cost of borrowing for NFCs



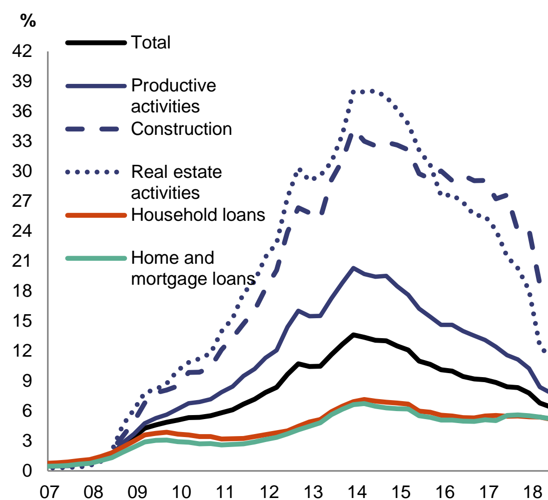
Source: ECB.

20. On aggregate, Spanish banks continued to reduce their non-performing loans during the first half of 2018. Against the background of continued positive economic developments over the past year, the total stock of NPLs for credit business in Spain in both the corporate and household segment decreased by EUR 28 billion (26%) y-o-y reaching EUR 79 billion in June 2018. In a context of still relatively flat volumes of credit, the share of NPLs in total loans (NPL ratio) for credit business in Spain went down by two percentage points over the same period, reaching 6.4% in June 2018. By sectors, the reduction in NPL ratios has been driven mainly by the construction and real estate sectors, where the NPL ratios went down to 17.5% and 11.3% from 27.6% and 21.5% a year earlier (see Graph 3.6). The NPL ratio also fell for NFCs and households, to 7.8% and 5.2%, respectively, in June 2018 compared to 11.6% and 5.5% a year earlier. At consolidated level, data from the European Banking Authority (EBA) show that the NPL ratio for consolidated business of Spanish banks decreased y-o-y to 4.2% in June 2018 from 5.4% a year earlier, thus the ratio is below the euro area average (4.4% as of June 2018) and the gap with the EU average (3.6% as of June 2018) has been reduced. By contrast, as regards provisioning levels, EBA data show a widening of the gap with the EU average. This is the result of a slight fall, in y-o-y terms, of the coverage ratio in Spain, to 44.2% in June 2018 and a higher ratio for the EU (to 46%).

21. In the first half of 2018, banks further reduced their forborne exposures, lowering their forbearance ratio down to 4.6% in June 2018 (compared to 5.6% a year earlier). However, the ratio remains double the ratio of the EU average (2.3% in the same date) showing that there is still room for further reduction.

22. Further progress has been made in the restructuring of the banking sector. The entire Spanish banking sector and not only the state-aided banks has optimised its business model and lowered its cost base. Further consolidation and cost optimisation is resulting from the merger of the (majority) state-owned Bankia and BMN finalised in January 2018. Between end-2012 and June 2018, the number of credit institutions declined by almost a quarter, while the branch network shrank by almost 30%. In the past five years, the number of employees also fell by almost 20%. Accordingly, Spanish banks have much higher levels of cost efficiency than the EU average, with a cost-to-income ratio of 51.8% in Spain vs. 63.4% at EU level in June 2018 according to EBA data.

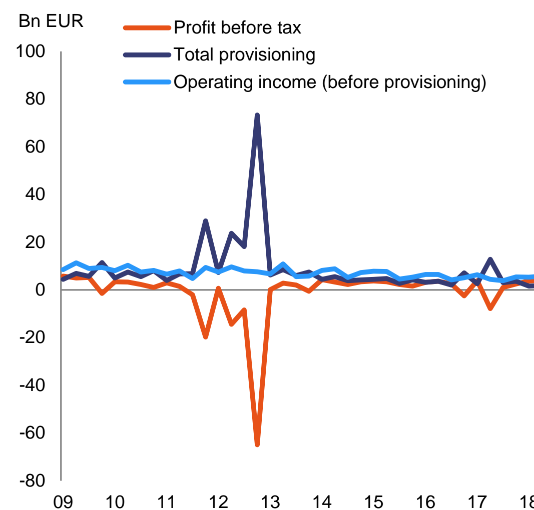
Graph 3.6: Ratio of non-performing loans



(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. Amidst the continued favourable economic environment, the banking sector has recorded good levels of profits during the first six months of 2018. Spanish domestic bank profits reached EUR 6.7 billion in the first half of this year, leading to a return on equity (ROE) in Spain of 6.2% in June 2018 (5.9% a year earlier). As regards the consolidated business, profits of Spanish banks reached EUR 10 billion with a corresponding ROE of 7.6% in June 2018 (7.1% a year earlier). According to EBA data, that only includes the most significant banks by jurisdiction, the ROE of Spanish banks increased to 8.9% in June 2018 (8.3% a year earlier) and is well above the EU average (7.1%).

Graph 3.7: Bank sector profitability for domestic operations



Source: BdE, own calculations.

24. Despite the profits recorded in the first half of the year, the capital position of Spanish banks slightly deteriorated. According to EBA data, the fully loaded common equity tier 1 (CET 1) ratio decreased for the Spanish banks from 11.4% at end-2017 to 11.1% at end-June 2018 and remains more than 3 percentage points below the EU average (14.3%). Nevertheless, the capital position still improved y-o-y since June 2017 when the fully loaded CET 1 ratio was 10.6% (50 basis point lower). The results of the 2018 EU wide stress test exercise published on 2 November 2018, show adequate resilience of the four stress-tested Spanish banks in the event of a potential adverse scenario.

4. FINANCIAL SECTOR REFORMS AND POLICY

4.1. SAREB – RECENT DEVELOPMENTS AND OUTLOOK

25. The liquidation of SAREB's assets – both loans and real estate – in H1 2018 was slower than planned and the company continued to post net losses. In addition, the company's margins, in particular on loans, slightly decreased compared to 2017, on account of the low quality of assets put on sale and increased competition on the NPLs market. To address the problem of squeezed margins, SAREB pursued its strategy of transforming loans into more profitable real-estate owned assets (REOs). The company continued to miss its annual budgetary objectives set in the business plan. This is due to real estate assets being often concentrated in areas with slower than expected recovery of prices. Furthermore, the legal and administrative proceedings to convert loans into foreclosed assets were delayed. This might impede their quick liquidation. SAREB's total income in 2018-H1 amounted to almost EUR 1.6 billion compared to EUR 3.8 billion achieved in 2017. Loans accounted for more than EUR 980 million revenue, and the remaining EUR 590 million derived from the sale of REOs. In the first half of the year, the company booked a loss of EUR 309 million (against EUR 565 million recorded in 2017).

26. In 2018-H1, SAREB launched a new vehicle to manage its residential rental portfolio of real estate assets. Tempore Properties is listed on the alternative stock exchange market and SAREB owns 98% of the new entity. It currently manages more than 1.400 residential units in Catalonia, Community of Madrid, Community of Valencia, Andalusia and Castilla la Mancha. It is planned that new assets will be transferred to Tempore gradually. According to SAREB, the new company has good profitability prospects given the quickly growing residential rental market in Spain.

27. With a view to the upcoming expiry of contracts with its servicers, SAREB is planning to introduce a new asset management strategy. This will result in a more direct involvement of SAREB in the management of assets and information, with the objective to better control them and diminish dependence on servicers. Among others, this will imply a stronger presence of SAREB at regional level. There are however, several uncertainties related to the new strategy, such as, among others, operating costs and the impact of the transition on the company results.

4.2. PROGRESS WITH FINANCIAL SECTOR REFORMS AND CHALLENGES AHEAD

28. Resolution plans for Spanish banks under the bank recovery and resolution directive (BRRD) are well on track whereas MREL targets await. Resolution plans are being drafted or approved for all Spanish banks, including significant, less significant and small institutions. MREL planning is ongoing and targets for the three significant banks – college banks – were already disclosed. No targets have been determined yet for less significant institutions. The Single Resolution Board (SRB) is expected to communicate these by the end of 2019. Depending on the required MREL-qualifying instruments level and the length of the transition period, in particular some small deposit-funded institutions could face some challenges to tap the market if needed.

29. The Spanish government is working on the creation of a macro-prudential authority. In July, the newly appointed Minister of Economy announced the creation of a new macro-prudential authority in order to enhance macro-prudential policy which was followed in November by a further announcement on the foreseen composition and powers of the new authority. Specifically, the Spanish authorities have decided to reactivate the creation of a macro-prudential authority in the form of a financial stability council.([18]) This will be implemented by substituting the recently reconvened *Consejo de Estabilidad Financiera* (CESFI). The authority, *Autoridad Nacional de Estabilidad Financiera,* (ANESFI) will be

([18]) The ESRB/2011/3 is not prescriptive on the type of institution in charge of macro-prudential policy. In this regard, national authorities may decide to create an independent body or a financial stability council: *"Designate in the national legislation an authority entrusted with the conduct of macroprudential policy, generally either as a single institution or as a board composed of the authorities whose actions have a material impact on financial stability. The national legislation should specify the decision-making process of the governing body of the macro-prudential authority".*

integrated by members of the Banco de España (BdE), the *Comisión Nacional del Mercado de Valores* (CNMV) and the Ministry of Economy. ANESFI council will be chaired by the Minister of Economy. The sectoral supervisors will continue to hold the regulatory firepower of the activation of macro-prudential instruments, while ANESFI will be empowered with the capacity to issue opinions, warnings and recommendations as a result of identified systemic risks. The set-up of this new authority will be accompanied by an expansion of the macroprudential toolkit of Banco de España, including borrower-based tools.

30. The BdE will be able to activate new macro-prudential instruments. In the context of the creation of ANESFI, BdE competencies will be reinforced in order to tackle potential economic sectors imbalances. In this regard, BdE will be empowered to set borrower-based tools, countercyclical sectorial buffer, as well as, exposures limits in a concrete sector. The new framework will confirm the BdE as the permanent competent authority with regards to Art. 458 of the Capital Requirements Regulation (CRR).

31. The Banco de España decided to keep the counter-cyclical capital buffer (CCyB) unchanged. Under the existing Law 10/2014, on 7 June Banco de España decided to maintain countercyclical capital macro-prudential requirements at 0% for the third quarter of 2018, due to the evolution of credit growth. According to Banco de España the analysis of the indicators that warn on the emergence of systemic risk associated with excessive credit growth currently advises against setting the CCyB above 0%. The credit-to-GDP gap was still negative in December 2017 (-50.9 percentage points), far from the level of 2 percentage points set by the Banco de España as a reference for the activation of the buffer.

32. Although overall profitability in the banking sector is gradually improving, banks are still under pressure due to low interest rates. The protracted period of low interest rates has continued to affect banks' interest margins. In order to offset this effect, banks might feel inclined to take higher risk in the provision of new loans. This could potentially increase NPLs in the future. Against this background, credit institutions and supervisors need to ensure sufficiently conservative credit standards. In addition, litigation costs in the form of compensation to consumers following some court rulings for some banks could put further downward pressure on profitability.

33. The Spanish Supreme Court confirmed the existing practice on who pays mortgage tax. The government immediately amended the Law. The Supreme Court revised its ruling from mid-October according to which credit institutions would be required to pay the mortgage stamp duties instead of the borrowers. After some weeks of uncertainty, the Court confirmed that clients would continue to have to pay mortgage duties, confirming 20-year-long practice. This final ruling made clear that banks will not have to assume possible retroactive payments of such taxes. Their impact on banks' balance sheets would have been significant. The government immediately reacted to this ruling and amended the Law (via a Royal-Decree Law 17/2018). Under this, for newly granted mortgages banks will have to pay this tax. This new burden on the banking sector could lead to some effects on the new production of credit and the rates or other fees to be paid by bank clients.

34. The government awaits better market conditions to pursue the reprivatisation of Bankia. The privatisation process of Bankia needs to be completed. The authorities need to find and use the best market opportunities to sell its remaining stake in the bank with a view to maximising the proceeds to be returned to the State.

ANNEX A

Main macroeconomic and financial indicators

Table A.1: Main macroeconomic and financial indicators

	1995 -1999	2000 -2004	2005 -2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018 (e)	2019 (f)
Core indicators														
GDP growth rate	3.6	3.7	3.2	- 3.6	0.0	- 1.0	- 2.9	- 1.7	1.4	3.6	3.2	3.0	2.6	2.2
of which domestic demand incl. stocks	4.1	4.3	3.7	- 6.4	- 0.5	- 3.1	- 5.1	- 3.2	1.9	3.9	2.4	2.9	2.8	2.2
Private consumption (annual % change)	3.3	3.5	2.6	- 3.6	0.3	- 2.4	- 3.5	- 3.1	1.5	3.0	2.9	2.5	2.3	1.8
Public consumption (annual % change)	2.7	4.7	5.7	4.1	1.5	- 0.3	- 4.7	- 2.1	- 0.3	2.0	1.0	1.9	1.9	1.7
HICP (annual % change)	2.8	3.2	3.5	- 0.2	2.0	3.0	2.4	1.5	- 0.2	- 0.6	- 0.3	2.0	1.8	1.7
Unemployment rate (% of labour force)	17.8	11.3	9.3	17.9	19.9	21.4	24.8	26.1	24.5	22.1	19.6	17.2	15.6	14.4
Gross fixed capital formation (% of GDP)	22.9	27.0	30.3	24.3	23.0	21.5	19.8	18.8	19.3	19.9	19.9	20.5	21.3	21.8
Gross national saving (% of GDP)	21.9	23.0	21.7	20.3	19.7	18.6	19.5	20.2	20.4	21.5	22.6	23.0	23.1	23.3
General Government (% of GDP)														
Balance (g)	- 4.1	- 0.5	0.2	- 11.0	- 9.4	- 9.6	- 10.5	- 7.0	- 6.0	- 5.3	- 4.5	- 3.1	- 2.7	- 2.1
Gross debt	63.0	51.3	39.1	52.8	60.1	69.5	85.7	95.5	100.4	99.3	99.0	98.1	96.9	96.2
Interest expenditure	4.4	2.6	1.6	1.7	1.9	2.5	3.0	3.5	3.5	3.1	2.8	2.6	2.4	2.3
Households														
Households saving rate	12.8	10.8	7.8	13.4	10.1	10.8	8.6	9.6	9.3	8.7	7.8	5.5	4.5	5.1
Rest of the world (% of GDP)														
Trade balance	- 0.7	- 2.7	- 5.5	- 1.2	- 1.3	- 0.2	1.5	3.3	2.4	2.3	3.2	2.9	2.2	2.0
Trade balance, goods	- 3.6	- 5.8	- 8.2	- 3.8	- 4.4	- 4.2	- 2.8	- 1.4	- 2.1	- 2.0	- 1.4	- 1.9	- 2.3	- 2.4
Trade balance, services	2.9	3.1	2.7	2.7	3.1	3.9	4.3	4.6	4.6	4.3	4.5	4.8	4.5	4.4
Current account balance	- 1.4	- 4.3	- 8.9	- 4.3	- 3.9	- 3.3	- 0.4	1.5	1.0	1.1	2.2	1.9	1.2	1.0
Net financial assets	- 27.8	- 42.2	- 70.0	- 89.6	- 84.8	- 89.6	- 91.2	- 93.6	- 96.8	- 90.0	- 84.4	- 82.1	- 81.5	n.a.
Net international investment position (h)	- 28.8	- 44.3	- 71.6	- 93.5	- 88.6	- 91.9	- 89.9	- 95.2	- 98.0	- 89.5	- 85.3	- 83.8	- 82.4	n.a.
Competitiveness (index, 2005=100)														
Real effective exchange rate relative to the rest of the euro area	87.2	91.6	100.3	101.1	100.0	98.5	94.1	92.5	91.9	92.2	91.0	90.3	89.6	90.3
Real effective exchange rate relative to the rest of the European Union	88.4	89.9	98.4	102.4	100.0	98.6	93.7	92.6	91.7	91.0	90.6	90.3	89.6	90.1
Real effective exchange rate relative to the rest of 37 industrialised countries	87.6	88.0	99.7	104.2	100.0	98.7	92.6	93.2	92.7	89.6	88.8	89.3	90.1	90.4
Banking sector														
Assets (% of GDP)	170.8	189.9	267.9	319.4	321.1	338.3	344.4	307.3	286.5	261.6	243.8	233.5	219.2	n.a.
Private domestic credit (y-o-y %)	11.8	14.7	18.9	- 1.6	0.8	- 3.2	- 9.9	- 10.2	- 6.5	- 4.2	- 4.1	- 2.0	- 3.1	n.a.
Non-performing loans (NPLs), total (%) (i)	3.3	1.1	1.5	5.1	5.8	7.8	10.4	13.6	12.5	10.1	9.1	7.8	6.3	n.a.
NPLs, productive activities (%)	n.a.	1.2	1.5	6.2	7.9	11.3	15.5	20.3	18.5	14.6	13.1	10.3	7.8	n.a.
" of which, construction, and (%)	n.a.	1.0	1.7	8.5	12.1	18.2	25.8	34.3	32.6	30.0	29.1	24.1	17.5	n.a.
" real estate activities (%)	n.a.	0.6	1.8	10.1	14.0	21.4	29.1	38.0	36.2	27.5	25.5	18.1	11.3	n.a.
NPLs, residential mortgages (%)	n.a.	0.4	1.0	2.9	2.6	3.1	4.4	6.6	6.2	5.1	5.1	5.5	5.2	n.a.
Tier 1 ratio (%)	n.a.	n.a.	n.a.	9.3	9.6	10.2	9.7	11.7	11.7	12.6	12.9	13.2	13.2	n.a.
Interest rates														
10 year spread vis-à-vis the Bund (%)	1.6	0.2	0.1	0.8	1.5	2.8	4.3	3.0	1.5	1.2	1.3	1.2	0.9	n.a.
CDS 5 year (basis points)	n.a.	n.a.	14.6	92.0	204.0	319.6	431.9	235.4	90.5	84.1	82.1	67.4	55.3	n.a.

Updated on 08 Nov 2018

(e) 2018: forecast or latest available data
(f) forecast
(g) General government balances include capital transfers related to support of banks
(h) ESA2010 and BPM6
(i) NPLs: ratios, in % of total loans
Source: Ameco, BdE, Bloomberg, Eurostat, Macrobond

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