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Post-Programme Surveillance Report

Spain, Autumn 2017

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Directorate-General for Economic and Financial Affairs

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The cut-off date for the data included in this report is 31 October 2017

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ABBREVIATIONS

BdE	Banco de España, Bank of Spain
BFA	Banco Financiero y de Ahorros, S.A.
BMN	Banco Mare Nostrum
BRRD	Bank Recovery and Resolution Directive
CCyB	countercyclical buffer
CDS	Credit Default Swap
CEISS	Banco de Caja España de Inversiones, Salamanca y Soria, S.A.
CERSA	Compañía Española de Reafianzamiento, S.A., The Spanish Rebonding Company
CNMV	Comisión Nacional del Mercado de Valores, National Securities Market Commission
CoCos	Contingent Convertible securities
CSRs	Country-Specific Recommendations
DBP	Draft Budgetary Plan
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ESM	European Stability Mechanism
FROB	formerly Fondo de Reestructuración Ordenada Bancaria, now Autoridad de Resolución Ejecutiva, the Spanish Executive Resolution Authority
ICO	Instituto de Crédito Oficial, a state owned bank attached to the Spanish Ministry of Economic Affairs and Competitiveness
IFRS	International Financial Reporting Standards
INE	Instituto Nacional de Estadística, the Spanish National Statistics Institute
IPO	Initial Public Offering
LTD	Loans-to-Deposits
MARF	Mercado Alternativo de Renta Fija, Alternative Fixed Income Market
MREL	Minimum Requirement for own funds and Eligible Liabilities
MRO	Main Refinancing Operations
NIIP	Net International Investment Position
NPLs	Non-Performing Loans
PPS	Post Programme Surveillance
RDL	Real Decreto-ley, Royal Decree-Law
REOs	Real Estate Owned
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 Enterprises
SRB	Single Resolution Board
SRMR	Single Resolution Mechanism Regulation
y-o-y	year on year

EXECUTIVE SUMMARY

This eighth 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 eighth post-programme surveillance visit to Spain on 16-18 October 2017. The European Stability Mechanism (ESM) participated in the meetings on aspects relating to its own Early Warning System. The report focuses on macroeconomic and financial sector developments, 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.

After accelerating in the first half of 2017, GDP growth is expected to ease but remain strong over the next two years. Economic activity is driven by strong domestic demand, in particular private consumption, but net exports are also giving a firmly positive contribution to growth. Real GDP growth is projected to decelerate over the medium term, but remain above the EU average. Job creation is also expected to moderate, but remain solid, and unemployment will continue to decline. Inflation, after picking up in the first half of this year due to the increase in oil prices, is expected to moderate over the coming quarters. Although market tensions in response to recent events in Catalonia have remained contained, the risk exists that future developments could have a negative impact on growth, the size of which cannot be anticipated at this stage.

Amid continued strong economic growth, banks have further adjusted their business models and cost structures, in turn supporting growth by providing new loans to the economy. On aggregate, banks comfortably meet the regulatory capital requirements and the quality of their assets has further strengthened, as the level and ratio of non-performing loans continues to drop. Only a few institutions are still dealing with the challenge of significant legacy assets in their balance sheets. The implementation of the restructuring plans of the Spanish banks that have received state aid is very close to completion and has fostered the viability of those banks. The banking sector at large was strengthened by the successful resolution of Banco Popular in June, with no losses for taxpayers or depositors, and the successful IPO of Unicaja. The preparation of the merger of state-owned Bankia and Banco Mare Nostrum is well advanced. Resuming the selling of the ownership stake of FROB in the merged entity and further divesting some banking foundations in savings banks will further reinforce the Spanish banking sector. More broadly, the swift and full implementation of the reform of the savings bank sector, in line with the original plan, remains important.

Spanish banks have continued to be profitable, but, as for their European peers, sustaining sufficient profitability over the medium term remains a key challenge for many institutions. This is due to low interest rate margins, diminishing scope for gains in operational efficiency and still subdued lending activity. Against this background, some Spanish credit institutions will have to continue to adapt their business models.

Advancing the divestment of its portfolio in a profitable manner represents a challenge for the asset management company SAREB. SAREB([1]) has continued to address some major legacy problems stemming from the crisis by progressing on the divestment of its portfolio. Nonetheless, its financial results have not yet improved, which calls for further efforts to improve its activity.

Strong and balanced growth, coupled with dynamic job creation, supports the correction of macroeconomic imbalances, but challenges remain. A more balanced growth pattern than in the pre-crisis years is supporting the strong recovery and imbalances are unwinding. The reduction of private sector debt has progressed further, both for households and corporates. However, deleveraging needs are still present in some segments of the economy, and the high level of private and public debt is reflected in a sizeable amount of external liabilities. Low productivity growth, in particular due to subdued total factor productivity growth, makes competitiveness gains hinge upon cost advantages. The decrease in

([1]) Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A. (SAREB).

unemployment since 2013, to 16.4% of the labour force in the third quarter of 2017, has been remarkable, also thanks to the labour market reforms undertaken in recent years. Nevertheless, the unemployment rate remains among the highest in the EU, especially among young and low-skilled workers.

Spain's general government deficit has continued to narrow, mainly supported by the strong economic growth. After recording a headline deficit in 2016 of 4.5% of GDP, the Spanish government balance continued to improve in the first half of 2017. However, Spain is projected to record the highest general government deficit (in % of GDP) in the EU in 2017, warranting continued effort to reduce the deficit in line with the Stability and Growth Pact requirements. Based on the Commission 2017 autumn forecast and Spain's Draft Budgetary Plan (DBP), the Commission will assess Spain's compliance with the provisions of the Stability and Growth Pact on 22 November 2017.

Ensuring a balanced, durable and inclusive growth path over the long term remains a challenge. While robust growth continues to support the rebalancing of the Spanish economy and the stabilisation of the financial sector, continued efforts are needed to sustain the resilience of the banking sector. The consolidation effort to ensure a durable reduction of the general government deficit and debt, in line with the fiscal adjustment path set by the Council, needs to continue. Importantly, the structural reform agenda needs to be resumed, avoiding backtracking on past reforms, with a view to furthering the rebalancing of the economy, bringing the unemployed back to work and raising Spain's productivity and growth potential.

On the basis of the analysis in the report, repayment risks for the ESM loan appear very low. On 26 October 2017, the Board of Directors of the ESM approved the sixth voluntary early repayment for Spain. The next post-programme surveillance mission will take place in spring 2018.

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]) Since July 2014, Spain has made five voluntary early repayments. On 26 October 2017, the Board of Directors of the European Stability Mechanism (ESM) approved a sixth voluntary repayment of EUR 2.0 billion, following which the outstanding amount of the ESM loan stands at EUR 31.7 billion.

2. Staff from the European Commission, in liaison with the European Central Bank, undertook the eighth post-programme review mission to Spain from 16 to 18 October 2017. 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 2017.([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 seventh PPS report: https://ec.europa.eu/info/publications/economy-finance/post-programme-surveillance-report-spain-spring-2017_en.

3. The autumn 2017 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 2017 country report for Spain([6]), published on 22 February 2017 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 22 May 2017, the European Commission presented its 2017 country-specific recommendations (CSRs). The Commission proposed that the Council recommend that Spain([8]) pursue structural reforms in the areas of the labour market, social policy, education, and business regulation. It further called on Spain to promote investment in research and innovation and ensure compliance with the Council decision of 8 August 2016 giving notice under the excessive deficit procedure of the Stability and Growth Path([9]).

(6) https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-spain-en.pdf.

(7) https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-reports-comm-en.pdf .

(8) https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations_-_spain-es.pdf.

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

2. RECENT MACROECONOMIC AND FINANCIAL SECTOR DEVELOPMENTS

2.1. RECENT MACROECONOMIC DEVELOPMENTS

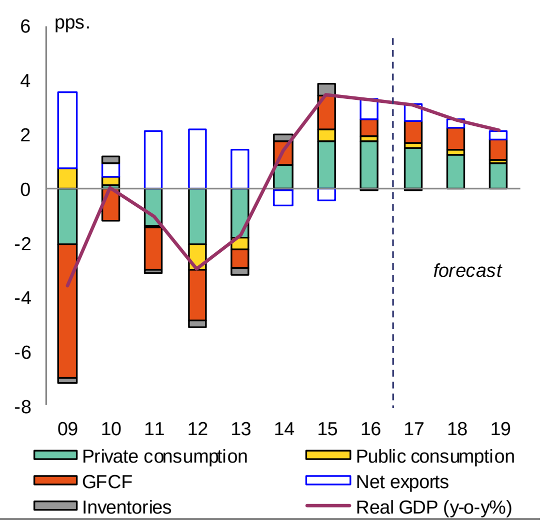
4. Economic growth continued exceeding expectations in the first three quarters of 2017. With its strong expansion in 2017-Q2, at 0.9% on a quarterly basis, the volume of GDP finally surpassed its pre-crisis peak. According to the flash estimate, growth remained robust in the third quarter of 2017, at 0.8% q-o-q. The expansion is underpinned by a more balanced growth pattern than before the crisis. Domestic demand, and specifically private consumption, remains the main driver of growth, but net exports have also been contributing firmly to growth since 2016. The strength of the recovery partly reflects the impact of the structural reforms implemented in recent years, in particular the financial sector and labour market reforms. The latter supported cost-competitiveness gains and boosted job creation.

5. The Commission 2017 autumn forecast expects economic growth to ease over the forecast horizon but remain robust. Real GDP growth is expected to reach 3.1% this year, before moderating to 2.5% in 2018 and 2.1% in 2019 (see Graph 2.1). ([10]) However, the risk exists that future developments in Catalonia could have a negative impact on growth, the size of which cannot be anticipated at this stage. Private consumption is expected to slow down as job creation decelerates and the tailwinds that supported the growth of disposable income in recent years - i.e. declining oil prices, tax cuts and improving financial conditions - abate. However, private consumption is still projected to remain the main contributor to growth over the forecast horizon, as disposable income continues to grow and the financial position of households improves. After decelerating in 2016, growth of investment is expected to rebound in 2017, driven mainly by residential construction. It is then set to decline slightly in 2018 and 2019, as equipment investment growth moderates in line with final demand.

([10]) The Commission 2017 autumn forecast does not incorporate the INE estimate for real GDP growth in the third quarter of 2017, as it was released after the cut-off date of the forecast.

6. The external sector is expected to continue contributing to growth over the forecast horizon. Since 2016, import growth has remained contained, despite strong growth of domestic demand and accelerating exports, pointing to a reduction in import propensity. At the same time, structural improvements in export performance, such as cost competitiveness gains and an increase in the number of regular exporters, have resulted in sizeable gains in market shares in recent years, and exports have continued to show dynamic growth. Both exports and imports are expected to accelerate this year as Spain's export markets recover, before moderating in 2018 and 2019. Exports are expected to continue outpacing imports, and net trade should make a positive contribution to growth over the forecast horizon. The current account surplus, after increasing in 2016, is forecast to decrease to 1.7% of GDP in 2017 as terms of trade worsen. It is then expected to increase in 2018 and 2019, as the trade balance of goods improves. In cyclically adjusted terms, the Spanish current account balance turned positive in 2016 for the first time in decades, confirming a structural improvement in trade performance.

Graph 2.1: **Composition of GDP growth**



GFCF: gross fixed capital formation
Source: INE, European Economic Forecast, autumn 2017

7. Core inflation is expected to gradually increase. After negative HICP in 2016, inflation rebounded strongly in the first half of this year due to the increase in oil prices. However, HICP inflation is forecast to moderate in the second half of this year to an annual average of 2% in 2017 and decline in 2018, as base effects of energy price increases fade away and the euro is assumed to appreciate. It will then increase slightly in 2019, as core inflation increases gradually due to the pickup in wages and the decline of the cyclical slack of the economy.

8. The housing market is consolidating its recovery. After the sharp adjustment that followed the crisis, the housing market and construction sector are recovering. Unsubsidised housing prices increased by 5.6% year-on-year in the second quarter of 2017.([11]) Prices of new dwellings went up by 4.4% and those of used dwellings by 5.8%. Moreover, during the three-month period ending in August 2017, the number of transactions on dwellings increased by 17.4% year-on-year, according to INE. However, residential investment is still much lower than before the crisis, and there remains a large stock of unsold houses.

9. Job creation is expected to remain strong but decelerate over the forecast horizon. According to the Labour Force Survey, employment growth decelerated slightly in the third quarter of 2017, but still recorded a strong 2.8% expansion year-on-year, with the number of people employed exceeding 19 million. Employment growth is expected to moderate further throughout 2018 and 2019, but full time equivalent employment is expected to grow by still robust rates of 2.1 % and 1.6%, respectively. Accordingly, the unemployment rate, which amounted to 16.4% of the labour force in the third quarter of 2017 (down from 18.9% one year earlier), is expected to fall to about 14% by 2019, still well above the pre-crisis level. Wage growth is projected to remain subdued this year despite the pickup in inflation, partly due to a negative wage drift, and then gradually increase in 2018 and 2019. At the same time, productivity is expected to grow only moderately, leading to modest increases in nominal unit labour costs until 2019. Still, cost-competitiveness gains vis-à-vis the euro area are expected to continue.

10. The general government deficit has continued to come down in the first half of 2017, helped by the strong economic growth. After attaining 4.5% of GDP in 2016, the general government deficit decreased by 0.9 pp compared to the first half of 2016. The Commission 2017 autumn forecast projects that the deficit will decline to 3.1% of GDP in 2017 and, on a no-policy change basis, to reach 2.4% of GDP in 2018 and 1.7% of GDP in 2019. The reduction of the deficit continues to rely to a large extent on the positive macroeconomic outlook, which is expected to support tax revenues and keep social transfers in check, as well as continued expenditure restraint. The prevailing favourable financing conditions and a slightly decreasing public debt ratio imply that interest expenditure is likely to continue to fall. Risks to the fiscal outlook relate to contingent liabilities, in particular the impact of any settlement involving the distressed toll motorways, and the uncertainty surrounding the macroeconomic scenario.

11. The public debt ratio is set to continue slowly decreasing, but remain at a high level over the forecast horizon. According to the Commission 2017 autumn forecast, gross general government debt will decrease from 99.0% in 2016 to 95.5% of GDP in 2019, as strong nominal GDP growth more than offsets the impact of the negative budget balance in all forecast years.

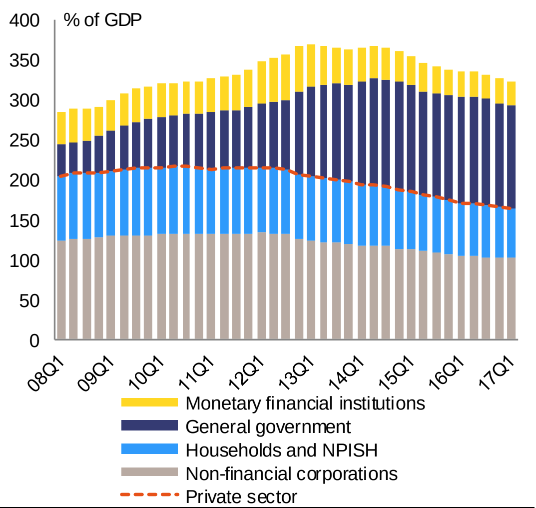
12. The household and corporate sectors have continued reducing their debt overhang over 2017, although at a slow pace. The total stock of debt of the private sector amounted to 160.1% of GDP in non-consolidated terms in the second quarter of 2017 (63.1% of GDP by households and 97% of GDP by non-financial corporations (NFCs); see Graph 2.2). This is 56.2% of GDP lower than its peak in the second quarter of 2010. ([12]) Although most of the debt reduction is attributable to non-financial corporations (a reduction of 33% of GDP), progress in households' deleveraging was also remarkable. The progressive amortisation of the credit stock and, more recently, robust economic growth have driven the reduction in debt ratios. The pace of reduction of outstanding debt has slowed down, as new credit has started

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

([12]) In consolidated terms, the NFC debt decreased from 117.7% in 2010-Q2 to 80.8% in 2017-Q2. Financial derivatives are excluded from these figures.

flowing again to SMEs and households (mainly as consumer credit). According to information from the BdE's Central Credit Register, while the total stock of outstanding credit to NFCs has decreased, the share of firms that increased or maintained their borrowing levels has risen. This reflects the fact that, while the deleveraging process continues, new credit is flowing to the most productive and less indebted companies, supporting investment and economic growth. Despite its reduction, the outstanding stock of private debt is still high in Spain, both for households and non-financial corporations, and vulnerable segments remain in some economic sectors (such as construction and real estate services) and households (such as low income or jobless households).

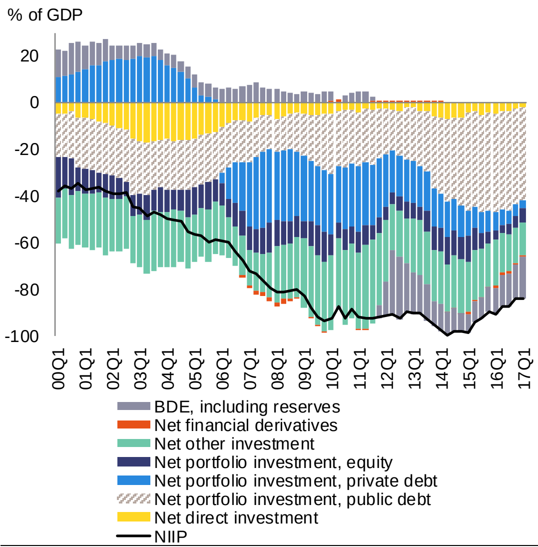
Graph 2.2: **Indebtedness by sector**



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

13. The still high level of private and public debt is reflected in a large amount of net external liabilities. Spain's net international investment position (NIIP) deteriorated in the first half of 2017, by 2.3 pps, to -86.2% of GDP. Negative valuation effects, owing to the appreciation of the euro, offset the positive impact of the improved net lender capacity of the Spanish economy. By institutional sector, the external debt of the public sector has increased, while private debt has declined (see Graph 2.3). Although much of the debt has long-term maturity and does not pose an immediate risk in terms of refinancing([13]), it still represents a vulnerability for the economy in case of shifts in market sentiment. Against this background, it will be crucial for Spain to continue recording current account surpluses over a sustained period of time in order to decisively bring down the still large negative NIIP.

Graph 2.3: **NIIP by financial instruments**



Source: BdE, own calculations.

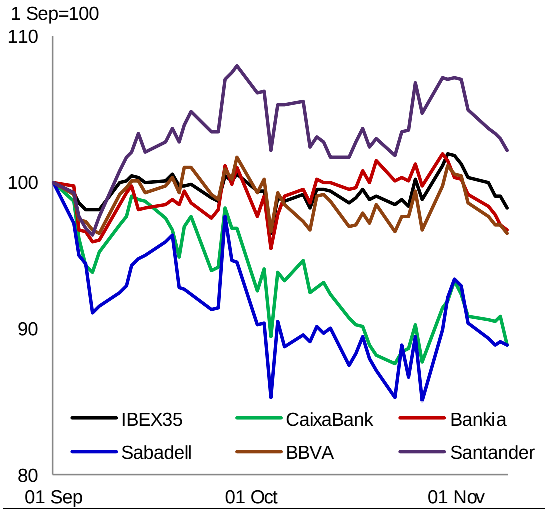
2.2. FINANCIAL SECTOR DEVELOPMENTS

14. Spain's financial sector proved resilient during the first three quarters of 2017 despite two domestic episodes of moderate volatility. The resolution of Banco Popular in June 2017 had no significant impact on financial stability. Only the share price of one mid-sized bank was considerably affected, amid concerns about contagion. As a result, the CNMV([14]) banned short sales of the shares of one of the banks for an extended period of time. Once it became clear that the contagion risks would not materialise, the shares of this institution partly recovered. On average, the share prices of banks have been on a slow but steady upward trend since the beginning of 2017. Further volatility in the banking sector was caused by the events in Catalonia, in October

([13]) In addition, BdE's external debt (net Target-2 liabilities) that is not subject to refinancing risk amounted to 38% of GDP in 2017-Q2.
([14]) Comisión Nacional del Mercado de Valores.

2017. Share prices of some credit institutions – in particular those based in, or more exposed to, the region – decreased by about 5% in October (see Graph 2.4). However, overall market reactions to recent events in Catalonia have remained contained.

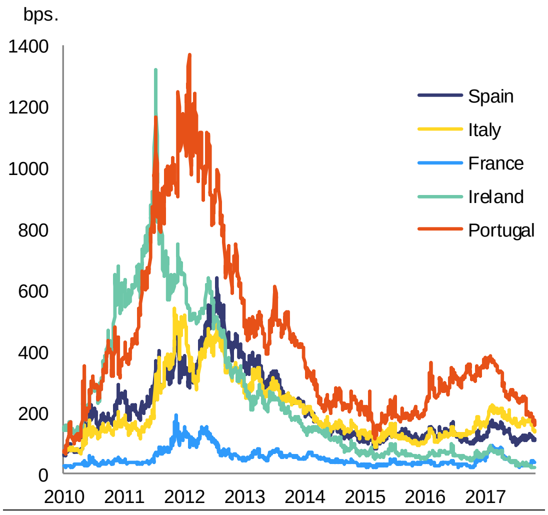
Graph 2.4: **IBEX35 and selected Spanish banks stocks**



Source: Madrid Stock Exchange via Macrobond, own calculations.

15. Market tensions related to the recent events in Catalonia have remained contained. After two banks moved their headquarters out of Catalonia to other regions in Spain, their stocks slowly rebounded. Similarly, the Spanish government bond yields and spreads increased at the beginning of October 2017, but declined again at the end of that same month (see Graph 2.5). The 5-year Spanish CDS spreads dropped from around 65 basis points in the first half of 2017 to 55 points in September 2017; they soared by 15 basis points due to heightened political uncertainty at the beginning of October 2017, but then quickly dropped again to the level recorded in September.

Graph 2.5: **Euro area sovereign spreads to the 10-year German bund**



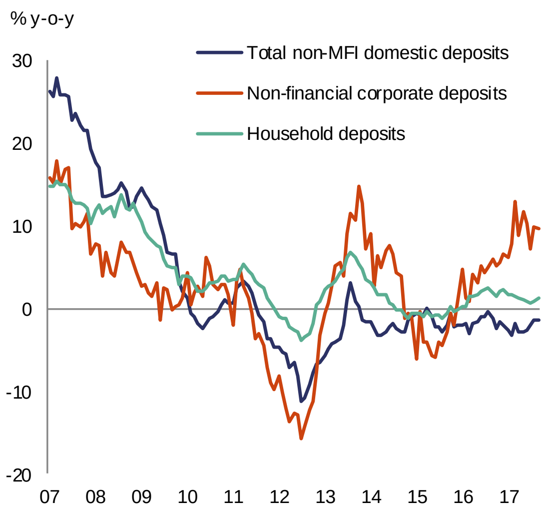
Source: IHS Markit, Macrobond, own calculations.

16. While access to ECB liquidity remains ample, Spanish banks are diversifying their funding sources. Bank deposits by the private non-financial sector significantly accelerated their growth. Total deposits of households increased by almost 1% y-o-y, while deposits of non-financial corporations increased their annual growth rate to almost 10% as of August 2017 (see Graph 2.6). At the same time, non-monetary financial institutions, insurance companies and pension funds continued to reduce their bank deposits at a rate of about 12% y-o-y. Overall, private domestic bank deposits were declining at an annual rate of 1.6 % as of August 2017. In the context of overall deleveraging of balance sheets and ample access to ECB liquidity, the need for wholesale and inter-bank funding continued to decline. Nevertheless their availability and costs improved further. In addition, the issuance of non-preferred debt instruments intensified, spurred by the upcoming MREL requirements([15]). The issuance of covered bonds for financial corporates remained depressed, but debt issuance by NFCs picked up. Spanish banks' total net borrowing from the Eurosystem, mostly comprised of TLTRO ([16]) operations, decreased significantly from its peak of EUR 389 billion in August 2012, to around EUR 170 billion in August 2017. However, since

([15]) MREL: Minimum Requirement for own funds and Eligible Liabilities.
([16]) TLTRO: Targeted Long-Term Refinancing Operation.

2016 it has increased by about EUR 33 billion due to the favourable terms of this financing source, and partly due to the effects of the ECB's Asset Purchase Programme. A temporary spike in borrowing by MRO([17]) operations was recorded in October.

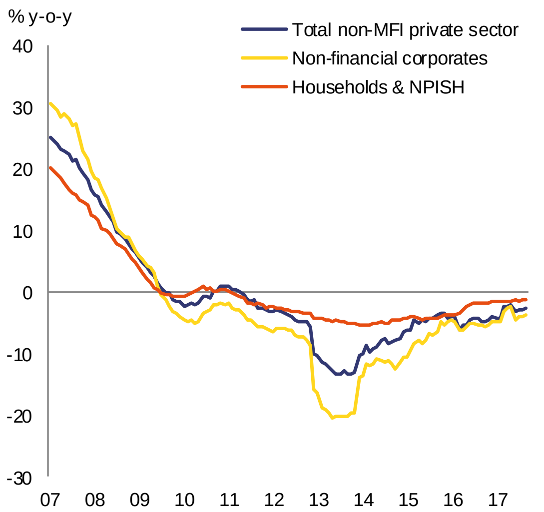
Graph 2.6: **Bank deposits**



Source: BdE.

17. The deleveraging of banks' balance sheets slowed down further as lending to SMEs and households accelerated. In August 2017, the reduction of banks' domestic assets declined further to about 2% y-o-y, in line with the overall decline of the stock of domestic private credit. The stock of credit to NFCs was still declining by 4% y-o-y in August 2017 (see Graph 2.7). However, including external borrowing and issuance of bonds, lending to NFCs increased by 2% y-o-y.([18]) New lending to SMEs (proxied by loans under EUR 1 million increased by around 7.5% y-o-y over the eighth months of 2017, whereas the volume of new loans over EUR 1 million increased by close to 4.5% y-o-y in August 2017. Over the same period, the stock of credit to households shrank by about 1% y-o-y, as the stock of consumer loans accelerated its growth to 15% y-o-y and the stock of mortgage loans slowed its pace of decline to 2.7% y-o-y.

Graph 2.7: **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 2017, credit standards for approving NFC's loans continued to tighten while they were eased for household lending. The easing concerned both mortgage and consumer lending. According to the BdE's Bank Lending Survey([19]) of October 2017, margins on loans for companies remained unchanged on average but they were further increased for riskier loans in the third quarter of 2017. The tightening of credit standards for approving NFC's loans was due to an increase in the cost of funds and a higher perception of risk. Margins on mortgage loans were again narrowed in Q3, with the exception of riskier loans for which they continued to widen. Overall, terms and conditions for consumer credit eased mainly on account of narrowing margins.

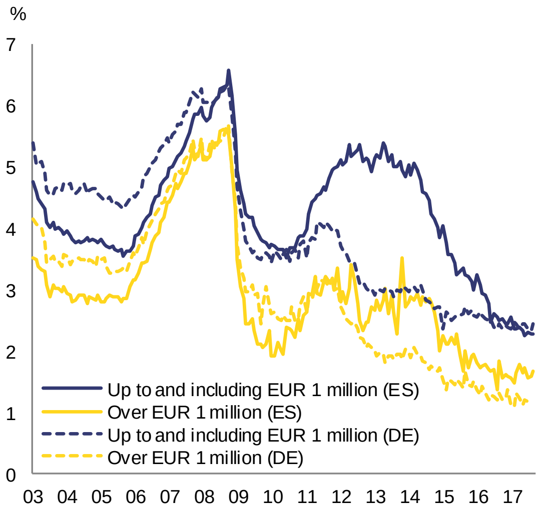
19. Access to finance and availability of bank credit is no longer considered an important problem by SMEs in Spain. This decline is in line with developments elsewhere in the euro area. In the latest SAFE survey([20]) (October 2016-March 2017), the share of respondents in the euro area considering access to finance their most pressing problem further declined to only 8.9%

([17]) MRO: Main Refinancing Operations.
([18]) According to the last Banco de España figures, when the write-off of bank loans is taken into account, the y-o-y growth rate of the stock of domestic bank credit of NFC modestly decreased in August.
http://www.bde.es/webbde/es/estadis/infoest/e0806e.pdf

([19]) See the report at:
http://www.bde.es/webbde/en/estadis/infoest/epb.html
([20]) Survey on the access to finance of small and medium-sized enterprise in the Euro Area at:
https://www.ecb.europa.eu/stats/money/surveys/sme/html/index.en.html

from a maximum of 32% in the second half of 2009. Access to finance represented the least important problem for the surveyed Spanish SMEs, with a percentage of 9.3% - close to the euro area average. The share of Spanish SMEs signalling an increase in the availability of bank loans went up from 26% to 28% from the previous six month period, and remained much higher than in European peers. In parallel, the average interest rate for new loans to NFCs of up to EUR 1 million (a proxy for SME finance) dropped from March to July 2017 by further 6 bps, to 2.29% overtaking again the rate charged in the same period in Germany (2.37 %).

Graph 2.8: **Cost of borrowing for NFCs**



Source: ECB.

20. On aggregate, Spanish banks continued to reduce their NPLs in the first three quarters of 2017. This reduction occurred in all classes of loans except for consumer loans, here NPLs slightly increased in parallel with the rapidly growing consumer lending. Following the work-out of impaired loans by banks, and against continued positive economic growth over the past year, the stock of NPLs fell by around EUR 15 billion y-o-y until August 2017, corresponding to a 12% reduction of the stock. This was due both to disposals and write-offs, as well as to cured loans. Meanwhile, the total volume of loans to NFCs and households decreased by about EUR 33 billion over the same period. As a result, the share of NPLs in total loans (NPL ratio) for businesses in Spain dropped from 9.4% in August 2016 to 8.5% one year later (see Graph 2.9). Data by the EBA show that the NPL ratio for consolidated business of Spanish banks dropped from 6% in June 2016 and 5.7% at end-2016 to 5.4% in June 2017, close to the EU average. This positive trend in asset quality was driven by loans to NFCs, including to the construction and real estate sectors where the NPL ratio declined to around 27% and 22% respectively in June 2017. The NPL ratio for household loans remained almost flat in H1 2017 at 5.5% of total loans. The decline in the volume of NPLs would have been higher without the impact of the new Annex 9 accounting rules, which toughened the classification criteria for performing loans. The resolution of Popular may play a positive role in accelerating the reduction in NPL ratios by some smaller banks which came under market pressure to clean-up their balance-sheets. Data by the EBA show a rise of the average ratio of coverage by provisions from 43.7% at end-2016 to 44.7% in June 2017, being very close to the EU average. The reduction in NPLs is being favoured by an increasing number of big sales of distressed assets([21]).

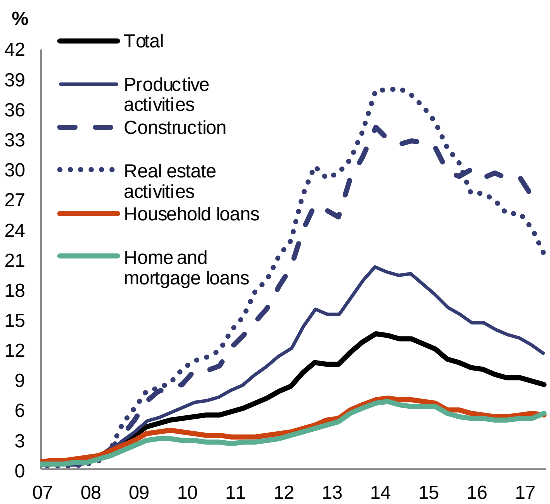
21. Banks further reduced forborne and foreclosed assets in the first half of 2017. According to EBA data, forborne loans continued decline and their ratio in total credit went down from 6.2% at end-2016 to 5.6% in June 2017. As in 2015, sales of existing foreclosed assets (amounting nearly 15% of the stock of foreclosures at the end of 2015), exceeded additions of new foreclosures (around 12.3% of the stock).

22. Restructuring of the banking sector has continued beyond state-aided banks. Since the crisis, the entire Spanish banking sector has significantly adjusted its business model and lowered its cost base, especially by reducing the branch network and the number of staff by 39% and 32%, respectively. By June 2017, the number of branches in Spain was reduced by about 7% y-o-y and the number of employees by more than 4%. Further consolidation of the domestic banking sector will result from the pending merger of the

([21]) At the beginning of August the purchasing entity of the resolved entity announced the sale of a EUR 30bn portfolio of distressed real estate assets, the biggest operation ever of that kind in Spain and one of the biggest in Europe.

two (majority) state-owned Bankia and BMN. Spanish banks continued to improve their efficiency in the first half of 2017 and according to data by the EBA their cost-to income ratio improved from 52.9% at end-2016 to 50.9% in June 2017, as compared with 0.43% and 6.4% in June 2016, respectively.

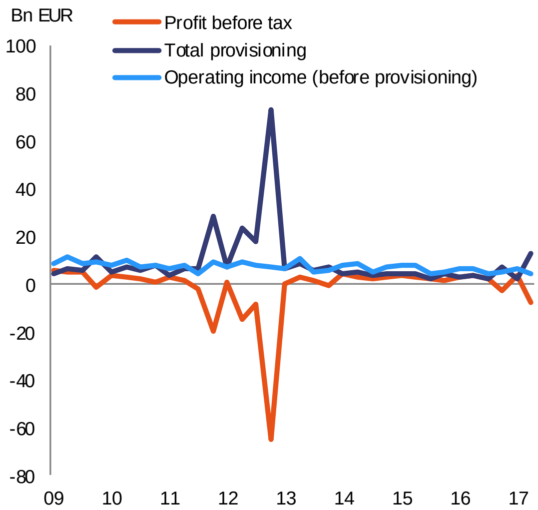
Graph 2.9: **Non-performing loans**



(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. Excluding the losses of the resolved bank, the first half of 2017 witnessed a rebound of banks' profits. In 2016, profits of Spanish banks were squeezed by very low interest rates, slow lending activity and increasing provisioning**.** Banks' net operating income declined by 8% from 2015 to 2016 and the provisioning effort remained at an elevated level of more than 70% of income (see Graph 2.10). As a result, the profit before tax for domestic operations declined by about 30% from 2015 to 2016. Due to the losses incurred by Banco Popular in the second quarter of 2017, the financial results became negative in the first half of 2017. Nevertheless, excluding the losses of this bank, bank profitability improved over the same period of last year, both for domestic operations (by about 4% y-o-y) and for the consolidated results which include operations abroad (by about 19% y-o-y). Both the ROA and the ROE increased for the consolidated operations to 0.5% and 7.1%, respectively as of June 2017.

Graph 2.10: **Bank sector profitability for domestic operations**



Source: BdE, own calculations.

24. The capital position of Spanish banks remained comfortable in the first half of 2017. The resolution of Banco Popular led to the reduction of the average common equity tier 1 ratio for the banking sector as a whole from 12.6% at end-2016 to 11.9% at end-June 2017, as its equity was written off. Nevertheless, this ratio has returned to its previous level by the capital issuance of the purchasing bank in July and it remains well above the regulatory and supervisory minima. The main driver of the higher capital levels in most banks was the internal generation of capital through profits and the issuance of equity and non-core capital instruments, such as contingent capital or subordinated debt instruments that qualify as own funds. Some smaller banks that accelerated the clean-up of their balance sheets are also taking measures to reinforce their capital buffers.

3. FINANCIAL SECTOR RESTRUCTURING AND REFORM

3.1. PROGRESS WITH BANK RESTRUCTURING

25. The implementation of the restructuring plans of state-aided banks is well advanced and should be completed by the end of the year. The burden-sharing exercises of banks have been completed. In terms of capacity, most of the banks have already reached their operational targets, while others continue reducing the number of branches and cutting their workforce. They also continue reducing their balance sheet size in line with their restructuring objectives. Banks are mostly on track on the required divestments of subsidiaries, although some specific sales are facing difficulties due to the complexities of selling real estate companies or selling/liquidating non-fully-owned subsidiaries. The monitoring of restructuring plans will continue until the end of the respective restructuring periods, normally by end 2017.

26. Banks continue adjusting their balance sheets and credit portfolios at a good pace in order to reach a balanced and sustainable business structure. Banks' liquidity and funding positions have been further strengthened. In particular, the loans-to-deposits (LTD) ratio and recourse to ECB funding are further receding for most of the entities. As far as solvency is concerned, all the restructured banks retained similar capital levels in 2016, compared to 2015. Those capital levels are comfortable, given that they have been increasing in previous years. NPLs have also continued to shrink over the first three quarters of 2017.

27. The sale of the State's stake in Bankia started in 2014 but has stalled. In 2014, the FROB sold its stakes in NCG Banco (now ABANCA) and Catalunya Banc to Banesco Group and BBVA respectively. It also started the disposal of Bankia shares, by selling on the market 7.5% of the shares held in Bankia by BFA. Since then, no further disposal of parts of Bankia has been carried out, due to rather weak bank equity market conditions and political uncertainty. However, Spain intends to resume the divestment process of Bankia, within the deadline for the divestments of public stakes in Bankia and BMN that was extended by two years (to December 2019) through a Royal Decree Law (RDL 4/2016) in order to ensure the most efficient use of public funds.

28. Some banks raised capital in order to repay aid and strengthen capital levels. Last June, Unicaja successfully carried out an IPO raising EUR 756 million equity from the market that were mainly used to repay in full to the state the EUR 604 million of aid in the form of CoCos([22]) from Banco CEISS. On 9 October, Liberbank's shareholders approved a EUR 500 million rights issue in order to speed up the bank's strategic objectives; the transaction is expected to be completed before year-end.

3.2. SAREB – RECENT DEVELOPMENTS AND OUTLOOK

29. SAREB accelerated divestments and made further operational progress against the background of a more dynamic real estate market. In addition, SAREB's new initiatives, such as the finalisation of an electronic platform for market retail loans and its commitment to litigate in courts by end-2018 the remaining portfolio of loans, whose borrowers have not collaborated with SAREB to speed up divestment, are welcome steps. They may improve sale margins, accelerate the disposal of real estate assets and give SAREB more negotiating power with its debtors. For the first half of 2017, SAREB recorded total income of EUR 1.7 billion, i.e. 21% higher than in the corresponding period of 2016. Most of the increase came from the sale and management of property that rose by 40% y-o-y to EUR 535 million. In the same period, SAREB sold more than 5,500 properties, which represented an annual increase of 68%.

30. At the same time, its financial results have not improved significantly in the first half of 2017. From its inception (2013) to June 2017, SAREB has been able to dispose of 25% of its assets and repay 19% of its senior government guaranteed bonds. The gap between its debt repayments and the reduction in its assets is expected to be closed by end-2017. This will help alleviate the high financial cost of the instruments it currently uses to hedge its interest rate risks. The

([22]) CoCos: Contingent Convertible securities.

conversion of loans into real-estate units (REOs) continued. The latter now represents 32% of the portfolio compared to 22% originally.

SAREB posted another loss in the first half of 2017. Notwithstanding the overall success of SAREB in contributing to the stabilisation of the Spanish banking sector over the past years, a pre-tax loss was recorded for the first half of 2017. It was slightly higher than the budgeted amount, but proportionally lower than the EUR 663 million pre-tax loss recorded for the whole 2016. Therefore, for the entire 2017 a smaller loss is expected than in 2016. This realised loss will impact the profit and loss account and reduce the current level of equity. The mark to market value of the interest rate swap is negative and represented a significant source of additional financial cost in 2016 and in the first half of 2017.

31. Several factors contributed to the recurrent negative financial results of SAREB. The most important ones are the slower than expected recovery of real estate prices despite an improvement in market dynamics, an underestimation before SAREB's inception of the costs of carrying its portfolio, the difficulty of accurately valuing the transferred assets and the significant financial cost of the interest rate swap.

32. The key determinant of SAREB's financial results remains the evolution of real estate prices. From peak to bottom, average Spanish real estate prices declined by about 40%. They now have started to grow again (see Chapter 2), but in many regions, prices have not recovered to pre-crisis levels yet. In addition, there is no guarantee that SAREB will benefit proportionally from the average price increase because its portfolio is geographically skewed: about 75% is located in areas where the price recovery was slower due to previous over-building.

3.3. PROGRESS WITH FINANCIAL SECTOR REFORMS

33. The resolution scheme for Banco Popular has been successfully implemented. This scheme, as adopted by the Single Resolution Board (SRB) and endorsed by the European Commission, was the first one adopted by the SRB under the BRRD. It added to the stability of the Spanish financial sector and demonstrated that the new European resolution framework is functioning. The bank was resolved in a proper and timely manner within a very short timeframe, with no losses for depositors or taxpayers and with good coordination among all the national and EU authorities involved. Most importantly, stability in the Spanish financial sector was not endangered. This is ultimately the aim of the entire EU resolution legislation (i.e. BRRD and SRMR). Losses were fully absorbed by regulatory capital instruments and did not entail either State aid nor aid from the Single Resolution Fund. The sale to Santander was subject to the regular regulatory review.

34. While the ICO([23]) lending activity remained stable in the first three quarters of 2017, it further developed other areas of specialisation. The new ICO's loans to NFCs provided through commercial banks (so-called second floor facilities) amounted to about EUR 5 billion in 2016. A similar volume of credit is expected to be lent in 2017. Amid the improving situation on the private credit market since 2016, ICO further focuses on providing export facilities (internationalisation of the economy), contributing to the Investment Plan for Europe, promoting the development of securitisation of SME lending portfolios, and in particular on boosting its AXIS subsidiary for venture and private equity capital. AXIS manages private equity funds among which the Fond ICO-Global is the largest with a total capital of EUR 1.5 billion to be disbursed over a period of 4 years since 2013. Its purpose is to invest – by means of transparent public tenders – in venture capital and private equity funds that seek to finance the development of Spanish firms. Nine tenders have been already organised for a total amount of almost EUR 1.3 billion. So far the funds have been invested in 342 companies with paid-out venture capital of EUR 368 million. The leverage of these funds is about 4.5 times.

35. Progress on other initiatives to strengthen non-bank financial intermediation, such as CERSA and MARF, continued in 2017. The State Compañía Española de Reafianzamiento (CERSA) acts as a guarantor of Spain's regional public guarantees offered to Spanish SMEs.

([23]) ICO: Instituto de Crédito Oficial, a state owned bank attached to the Spanish Ministry of Economy, Industry and Competitiveness.

CERSA's activity increased by 17% in 2016, reaching EUR 499 million in 2016 in counter-guarantees and benefiting 10639 firms. It has increased by a further 10% in the first half of 2017 compared to the same period of 2016, reaching 4321 firms for a total value of EUR 275 million of counter-guarantees issued. The SGR (Sociedad de Garantía Recíproca) system of CERSA granted EUR 1.2 billion in guarantees in 2016, an increase by 13% over 2015, benefiting 12800 firms. In addition, CERSA's coverage of the guarantees granted by the SGR increased substantially from 31% in 2012 to 58% in 2017. Another initiative is the Spanish Mercado Alternativo de Renta Fija (MARF), which was founded in 2013 as an alternative market for SME fixed-income securities. MARF has grown significantly in 2017 reaching almost EUR 2.4 billion in the total outstanding balances of its listed instruments in September (48% y-o-y increase).

36. The BdE continued to update its macro-prudential tools as required by Law 10/2014. The BdE introduced the countercyclical capital buffer (CCyB) in December 2015 to be applied from January 2016 onwards. However, the BdE set it at 0% in the light of current macroeconomic and credit developments. On the basis of an analysis of various indicators used to assess whether credit growth dynamics are excessive, BdE continued to set the buffer rate at 0% in September 2017 for the last quarter of the year. According to BdE data the credit-GDP gap was -59.6 pp as at March 2017, far below the levels above which BdE would consider increasing the countercyclical capital buffer.

4. CHALLENGES AHEAD FOR THE FINANCIAL SECTOR

37. In the context of compressed margins, sustaining profitability remains a challenge for the Spanish banks, as for their European peers. The protracted low interest rate environment supports the economic recovery and the reduction of non-performing loans. However, it also compresses interest margins. Litigation costs following some court rulings (in particular the European Court of Justice on the Spanish mortgage floor clauses) and, subsequently, the introduced compensation mechanisms, exert further downward pressure on some banks' profitability. In order to drive up profitability, banks are pushed to increase the supply of new credit, which may induce them to take greater risks. In this context, both banks and supervisors need to ensure a sufficiently conservative implementation of credit standards. Looking forward, while the successful and far-reaching restructuring of the Spanish banking sector over recent years has improved the efficiency of the banking sector, further efficiency gains can be achieved, e.g. by moving towards higher digitalisation.

38. NPLs are receding at a healthy pace for the aggregate banking sector, but some institutions still need to make further progress in the clean-up of their balance sheets. On average, NPLs continued to decrease, but legacy real estate assets are still posing a non-negligible risk for some banks. Following the resolution of Banco Popular, markets have pressed some banks into accelerating the clean-up of their balance sheets, with potential benefits going forward.

39. After the successful implementation of Banco Popular's transfer to Banco Santander, outstanding risks appear to be mostly related to potential litigation costs. Risks derived from potential litigation costs both for the acquirer and for the FROB need to be closely monitored.

40. The privatisation of Bankia, soon to be merged with BMN, needs to make further progress in line with market conditions. The deadline for the divestment of FROB from Bankia, set by Spanish law, is 2019. In this regard, the Spanish authorities need to make sufficient progress in the divestment of its public stakes. At the same time, they will also have to make good use of the conditions in capital markets in order to maximise the proceeds for the Spanish taxpayer.

41. A recent Royal Decree adopted by the government delays the implementation of the savings banks' reform. The new amended regime reduced the incentives for banking foundations to divest controlling stakes in former saving banks. Notwithstanding some recent or ongoing divestments by some banking foundations in their respective banks, the effective implementation of the agreed reform is key for the adequate success of the financial assistance programme and to support the stabilisation and regular functioning of the Spanish financial sector.

42. The implementation of the new EU accounting standards for provisioning will be a challenge for the whole sector, as in other EU Member States. The new accounting rules envisaged in the IFRS[24] framework will put additional pressure on banks' profitability and capital ratios. The impact will come from both the new portfolios for the measurement of financial assets and the implementation of the new expected loss model for credit losses. Overall, the potential impact of the new accounting rules does not appear to be sizeable for the banking sector as a whole, also due to the previously approved new accounting rules (Annex 9). However, supervisors should closely monitor the negative impact that the new regime could have on already squeezed profit and loss accounts of some banks.

43. SAREB needs to continue efforts to optimise its operations in order to finalise the divestment of its portfolio while protecting the value of its public funds over its lifetime. SAREB has undertaken various positive initiatives to optimise its activity, accelerate sales and achieve better margins. Nevertheless, given the persistence of negative financial results, further efforts are needed to improve its business.

44. Market tensions in response to recent events in Catalonia have remained contained. The risk exists that future developments could have a negative impact on the economy and the financial sector.

([24]) **I**nternational **F**inancial **R**eporting **S**tandards.

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 (f)	2018 (f)
Core indicators													
GDP growth rate	3.6	3.7	3.2	- 3.6	0.0	- 1.0	- 2.9	- 1.7	1.4	3.4	3.3	3.1	2.5
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	2.5	2.4	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	3.0	2.6	2.2
Public consumption (annual % change)	2.7	4.7	5.7	4.1	1.5	- 0.3	- 4.7	- 2.1	- 0.3	2.1	0.8	0.9	0.8
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	1.4
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	17.4	15.6
Gross fixed capital formation (% of GDP)	22.9	27.0	30.3	24.3	23.0	21.5	19.8	18.8	19.3	19.8	20.0	20.4	20.8
Gross national saving (% of GDP)	21.9	23.0	21.7	20.3	19.7	18.6	19.5	20.2	20.4	21.4	22.4	22.6	23.1
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	- 2.4
Gross debt	63.0	51.3	39.1	52.8	60.1	69.5	85.7	95.5	100.4	99.4	99.0	98.4	96.9
Interest expenditure	4.4	2.6	1.6	1.7	1.9	2.5	3.0	3.5	3.5	3.1	2.8	2.5	2.3
Households													
Households saving rate	12.8	10.8	7.8	13.4	10.1	10.8	8.6	9.6	9.3	8.6	7.7	6.6	6.4
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	3.0	2.9	3.3
Trade balance, goods	- 3.6	- 5.8	- 8.2	- 3.8	- 4.4	- 4.2	- 2.8	- 1.4	- 2.1	- 2.1	- 1.6	- 1.9	- 1.6
Trade balance, services	2.9	3.1	2.7	2.7	3.1	3.9	4.3	4.6	4.6	4.3	4.6	4.8	4.9
Current account balance	- 1.4	- 4.3	- 8.9	- 4.3	- 3.9	- 3.3	- 0.4	1.5	1.0	1.0	1.9	1.7	1.9
Net financial assets	- 27.7	- 42.0	- 70.2	- 90.2	- 85.4	- 90.2	- 91.9	- 93.8	- 96.6	- 89.2	- 83.8	n.a.	n.a.
Net international investment position (h)	- 28.8	- 44.3	- 71.6	- 93.5	- 88.6	- 91.9	- 89.9	- 95.2	- 97.8	- 89.7	- 83.9	n.a.	n.a.
Competitiveness (index, 2005=100)													
Real effective exchange rate relative to the rest of the euro area	87.3	91.7	100.3	101.1	100.0	98.4	94.0	92.4	91.8	92.9	91.5	90.7	90.3
Real effective exchange rate relative to the rest of the European Union	88.6	90.1	98.4	102.3	100.0	98.6	93.6	92.5	91.5	91.6	91.2	90.9	90.4
Real effective exchange rate relative to the rest of 37 industrialised countries	87.5	88.1	99.7	104.1	100.0	98.6	92.5	93.1	92.5	90.4	89.6	90.0	90.2
Banking sector													
Assets (% of GDP)	170.8	189.9	267.9	319.4	321.1	338.3	344.4	307.3	286.5	261.9	243.9	n.a.	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	n.a.	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	n.a.	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	n.a.	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	n.a.	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	n.a.	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	n.a.	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	n.a.	n.a.	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	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	61.7	n.a.

Updated on 31 Oct 2017

(f) 2017: forecast or latest available data
(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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