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Post-Programme Surveillance Report

Spain, Spring 2017

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Spain, Spring 2017

EUROPEAN ECONOMY Institutional Paper 056

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ABBREVIATIONS

BdE	Banco de España, Bank of Spain
BMN	Banco Mare Nostrum
CDS	Credit Default Swap
CERSA	Compañía Española de Reafianzamiento, S.A., The Spanish Rebonding Company
CRDIV	Capital Requirement Directive
CSPP	Corporate Sector Purchase Programme
CSRs	Country-Specific Recommendations
EC	European Commission
ECB	European Central Bank
EIF	European Investment Fund
ESM	European Stability Mechanism
HICP	Harmonized Index of Consumer Prices
IPO	Initial Public Offering
LTD	Loans-to-Deposits
MARF	Mercado Alternativo de Renta Fija, Alternative Fixed Income Market
NFCs	Non-Financial Corporations
NIIP	Net International Investment Position
NPLs	Non-Performing Loans
PPS	Post Programme Surveillance
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.
SRB	Single Resolution Board
y-o-y	year on year

EXECUTIVE SUMMARY

This seventh 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 seventh post-programme surveillance visit to Spain on 24-26 April 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 exceeding expectations in 2016, Spain's real GDP growth is expected to remain robust this year and the next. In 2016, economic activity expanded strongly, by 3.2%, the same rate as in the previous year and well above the euro area average. Domestic demand, and especially private consumption, remained the main driver of growth, but net exports also contributed. Growth was underpinned by favourable external and financing conditions and strong job creation, in turn supported by continued wage moderation and past reforms. Real GDP growth was again stronger than expected in the first quarter of this year and, according to the Commission 2017 spring forecast, is expected to remain robust in 2017 as a whole and in 2018, despite some moderation.

The financial sector is benefitting from the strong economic recovery. At the aggregate level, the banking system comfortably meets the regulatory capital requirements and the quality of banks' assets has further strengthened, with the non-performing loan ratio continuing its downward trend. Ample access to liquidity and low funding costs facilitated new bank lending, in particular to households and SMEs. This in turn supported economic activity. Overall, the Spanish banks continued to be profitable in 2016. However, as for other European banks, their profitability was squeezed by the low interest rate environment, subdued lending activity and ongoing provisioning efforts, also to cover for the European Court of Justice ruling from December 2016 on the Spanish mortgage floor clauses. Against this background, and in light of the challenges posed by the EU-wide bank restructuring and regulatory changes, the Spanish credit institutions need to adapt further their business models. In addition, despite being on a declining trend, NPLs are still higher than the EU median and represent a burden. Some smaller banks need to continue reinforcing their balance sheets.

On 7 June 2017, Banco Popular was resolved following difficulties linked to a significant portfolio of legacy real estate assets and rapidly deteriorating liquidity. The resolution scheme was the first adopted by the Single Resolution Board under EU bank recovery and resolution rules. It entailed the sale of Banco Popular to Banco Santander in order to ensure the continuity of the important functions performed by the bank, including full access by customers to deposits, and to avoid adverse effects on financial stability.

The implementation of the restructuring plans of the Spanish banks that have received state aid is well advanced and should be completed by the end of the year. The FROB([1]) has given the green light for the merger of state-owned Bankia and Banco Mare Nostrum, following a two-year extension for completing its divestment from the two banks, in order to maximise value for taxpayers. Continued restructuring of these banks, also after the merger, will strengthen the stability of the banking sector. A Royal Decree recently adopted by the government delays the full implementation of the original reform of the savings bank sector.

Advancing the divestment of its portfolio in a profitable manner represents a challenge for the asset management company SAREB. SAREB ([2]) has clearly been instrumental in the restructuring of the banking sector and in 2016, it continued divesting its portfolio. However, it still posted negative results

([1]) FROB stands for Spanish Executive Resolution Authority, http://www.frob.es
([2]) Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A. (SAREB)

last year. The ongoing recovery of the Spanish real estate market should help to improve SAREB's financial situation, but further sustained efforts are needed to optimise its operations and financial results.

Robust growth continues supporting the rebalancing of the economy, but the overall indebtedness of the country remains high. Private sector debt reduction has progressed at a fast pace, converging to the euro area average. However, deleveraging needs are still present in some parts of the economy and the still high level of private and public debt is reflected in a sizeable amount of external liabilities, which expose the country to shifts in market sentiment. Furthermore, low productivity growth, in particular total factor productivity growth, makes competitiveness gains hinge upon cost advantages. The decrease of unemployment has been remarkable over the past two years, but at 18.8% of the labour force in the first quarter of 2017, it remains among the highest in the EU and mainly affects youth and low-skilled workers. In addition, more than half of the unemployed have been without a job for more than one year. At the same time, only about half of the increase in employment in the last year is attributable to permanent contracts, and about a quarter of all workers had a temporary contract in the first quarter of 2017, and this rate has not decreased during the last year.

The public debt ratio is set to decrease only mildly until 2018. According to the Commission 2017 spring forecast, gross general government debt is set to decrease from 99.5% of GDP in 2016 to 98.5% of GDP in 2018, mainly thanks to strong nominal GDP growth. Spain is currently under the corrective arm of the Stability and Growth Pact, with deadline for correction of the excessive deficit at 2018. In 2016, the headline deficit reached 4.5% of GDP in 2016, below the 4.6% target set by the Council. The Commission 2017 spring forecast projects the headline deficit to decline further but remain above the targets set by the Council for 2017 and 2018, by 0.1% and 0.4% of GDP, respectively. The required fiscal effort over 2016-2017 is expected to be narrowly ensured, while in 2018, on a no-policy-change basis, the fiscal effort is forecast to fall short of what was requested by the Council. Against this background, on 22 May 2017 the Commission recommended the Council to recommend Spain to ensure compliance with the Council decision of 8 August 2016 giving notice under the excessive deficit procedure, including also measures to strengthen the fiscal and public procurement frameworks.([3])

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 any 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. Since July 2014, Spain has made five voluntary early repayments. The next post-programme surveillance mission will take place in autumn 2017.

([3]) https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations_-_spain_0.pdf

1. INTRODUCTION

1. Spain successfully exited the financial assistance programme for the recapitalisation of financial institutions in January 2014. The Programme had been agreed by the Eurogroup on 9 July 2012 for a period of 18 months([4]) 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.([5]) Since July 2014, Spain has made five voluntary early repayments, following which the outstanding amount of the European Stability Mechanism (ESM) loan stands at EUR 33.7 billion. Spain also announced the intention to make another early repayment in November 2017.

2. Staff from the European Commission, in liaison with the European Central Bank, undertook the seventh post-programme review mission to Spain from 24 to 26 April 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.([6]) 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 October 2016.([7])

3. On 7 June, the European Commission endorsed, under EU banking recovery and resolution rules, the resolution scheme of Banco Popular Español, S.A. In the context of months of market pressure after recording sizeable losses in 2016, and having confirmed a stressed liquidity situation, the Single Supervisory Mechanism (SSM) assessed Banco Popular as "failing or likely to fail", therefore triggering resolution. The resolution scheme, adopted by the Single Resolution Board, involved the sale of the bank to Spain's biggest banking group, Santander, and full protection of depositors while ensuring financial stability and avoiding the use of public funds

4. The spring 2017 PPS cycle 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([8]), published on 22 February 2017 in the context of the European Semester. That report includes 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([9]) Spain is also subject to surveillance under the corrective arm of the Stability and Growth Pact. In particular, on 8 August 2016, the Council requested Spain to put an end to the excessive deficit situation by 2018. On 22 May 2017, the European Commission presented its 2017 country-specific recommendations (CSRs), setting out its economic policy guidance for individual Member States for the next 12 to 18 months. The Commission proposed the Council to recommend Spain([10]) to pursue structural reforms in the areas of the labour

([4]) 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.

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

([6]) 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.

([7]) For more details see the sixth PPS report: https://ec.europa.eu/info/publications/economy-finance/post-programme-surveillance-report-spain-autumn-2016_en

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

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

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

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.

2. RECENT MACROECONOMIC AND FINANCIAL SECTOR DEVELOPMENTS

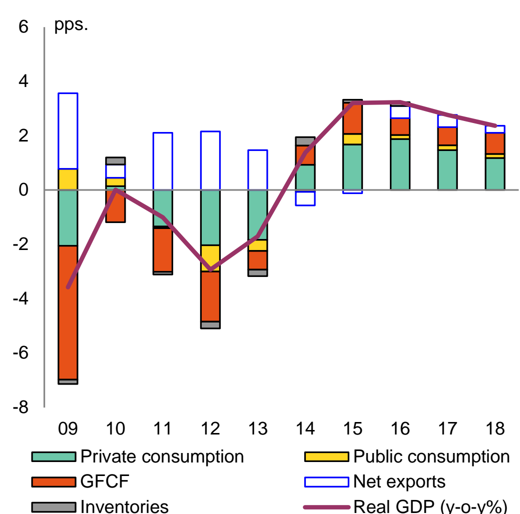
2.1. RECENT MACROECONOMIC DEVELOPMENTS

5. Economic growth continued exceeding expectations in 2016. On its fourth year of expansion, real GDP increased by 3.2%, the same rate as in the previous year and well above the euro area average. Real GDP growth in the first quarter of 2017 was again robust, at 0.8% q-o-q. The strength of the recovery partly reflects the impact of the structural reforms implemented in recent years, in particular the labour market reform that supported cost-competitiveness gains. The expansion is underpinned by a more balanced growth pattern than before the crisis. Domestic demand, and, specifically, private consumption, was the main driver of growth, but net exports also contributed.

6. The Commission 2017 spring forecast expects economic growth to ease over the forecast horizon but to remain robust. Real GDP growth is expected to moderate to 2.8% in 2017 and 2.4% in 2018 (see Graph 2.1). ([11]) Private consumption is expected to slow down as job creation decelerates and the tailwinds that supported growth of disposable income in recent years - i.e. declining oil prices, tax cuts and improving financial conditions - gradually abate. However, private consumption is still projected to remain the main contributor to growth over the forecast horizon. After decelerating in 2016, investment is expected to rebound modestly in 2017 and 2018, as the gradual recovery in residential construction investment more than offsets the projected moderation in equipment investment growth, in line with final demand.

7. The external sector is expected to contribute to growth over the forecast horizon. In 2016, the growth of both exports and imports decelerated. However, the contribution of the external sector to growth turned positive in 2016, as exports continued to gain sizeable market shares and outpaced import growth. Export growth is expected to accelerate in 2017, as Spain's main trading partners recover, before slowing down in 2018, as cost-competitiveness gains become more muted. Import growth is also forecast to pick up in 2017, before decelerating again in 2018 in line with slowing final demand. However, as growth of imports is expected to lag behind that of exports, net exports are set to give a positive, though declining, contribution to growth throughout the forecast horizon. After improving in 2016 (to 2% of GDP), the current account surplus is forecast to decrease in 2017 and stabilise in 2018, mostly due the impact of the expected worsening in terms of trade. In cyclically adjusted terms, the Spanish current account turned positive in 2016 for the first time in decades, signalling a structural improvement in trade performance. Cost-competitiveness gains that supported the increase in the number of regular exporters and early signs of import substitution underpin this improvement. Net external lending is expected to remain relatively stable at around 2% of GDP over the forecast horizon.

Graph 2.1: Composition of GDP growth



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

8. Short-term inflation dynamics continue to be dominated by changes in oil and energy prices, whereas wage developments will shape price dynamic in the medium term. Headline inflation (measured by the HICP) is expected to

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

turn positive, rising from -0.3% on average in 2016 to 2% in 2017. It would decrease to 1.4% in 2018, as the base effects of energy price increases fade away in the second half of 2017. Core inflation is expected to increase modestly over the forecast horizon, as wages gradually pick-up and the cyclical slack of the economy declines.

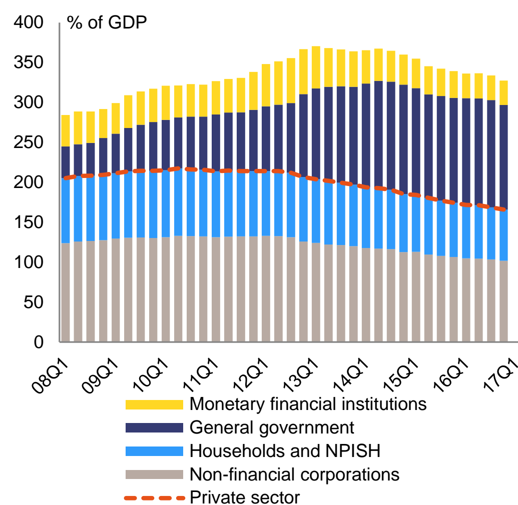
9. The housing market consolidates its recovery. After the sharp adjustment that followed the crisis, the housing market and the construction sector have recovered. Unsubsidised housing prices increased by 4.5% year-on-year in the fourth quarter of 2016. ([12]) Prices of new dwellings went up by 4.3% in the last quarter of 2016 and those of used dwellings by 4.5%. Moreover, in 2016 the number of transactions on dwellings increased by 13.7% year-on-year, according to INE. Despite these positive signs, there is still a large stock of unsold houses.

10. Job creation is expected to remain strong but decelerate over the forecast horizon. In 2016 employment increased by a strong 2.9% in full-time equivalent terms, although at a decelerating pace over the year. Employment growth reached 2.5% year-on-year in the first quarter 2017. This moderation is expected to continue gradually throughout 2017 and 2018, but full time equivalent employment is expected to grow by a still robust 2.3% and 2.1%, respectively. Accordingly, the unemployment rate, which amounted to 18.8% of the labour force in the first quarter of 2017, is expected to fall below 16% by 2018, still well above the pre-crisis level. Modest wage growth combined with low productivity gains is set to lead to moderate increases in nominal unit labour costs. Cost-competitiveness gains vis-à-vis the euro area are expected to continue, though slowing down.

11. Largely thanks to continued strong economic growth, Spain's general government deficit narrowed from 5.1% of GDP in 2015 to 4.5% of GDP in 2016. The Commission 2017 spring forecast projects the deficit to decline to 3.2% of GDP in 2017 and, on a no-policy change basis, to reach 2.6% of GDP in 2018. The reduction of the deficit continues to rely to a large extent on the positive macroeconomic outlook, which is expected to continue supporting tax revenues and keeping social transfers in check. In addition, improved financing conditions and a slightly decreasing public debt ratio imply that interest expenditure is likely to continue to fall. Some measures on corporate income taxation as well as expenditure control measures have also contributed to the deficit reduction in 2016 and will contribute further in 2017.

12. The public debt ratio is set to decrease mildly. According to the Commission 2017 spring forecast, gross general government debt will decrease from 99.4% in 2016 to 98.5% of GDP in 2018, as strong nominal GDP growth more than offsets the impact of the negative budget balance and debt-increasing stock-flow adjustments in both 2017 and 2018.

Graph 2.2: Indebtedness by sector



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

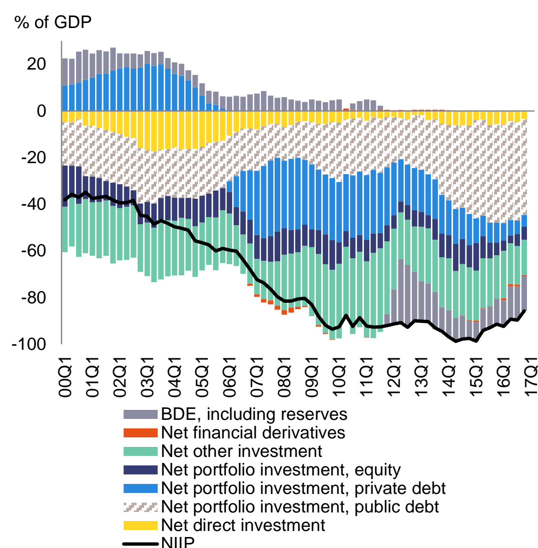
13. The household and corporate sectors continue reducing their debt overhang. The total stock of debt of the private sector amounted to 163.3% of GDP in non-consolidated terms at the end of 2016 (64.4% of GDP by households and 99% of GDP by non-financial corporations; see Graph 2.2). This is about 53% of GDP lower than at its peak in the second quarter of 2010. ([13])

([12]) Source: INE. Other data sources might present different results, but also a price recovery.

([13]) In consolidated terms, the NFC debt decreased from 117.7% in 2010 Q2 to 83% in 2016 Q4. Financial derivatives are excluded from these figures.

Although the largest share of the debt reduction is attributable to non-financial corporations (a reduction of 33% of GDP), progress in households' deleveraging was also quite remarkable. The progressive amortisation of the credit stock and, more recently, robust economic growth have been the main drivers of private sector deleveraging, while aggregate bank lending has been on a declining path since 2011. Behind this aggregate picture there are clear sectoral and company differences. Deleveraging is continuing especially in the construction and real estate sectors, while the financial sector is channelling funds to healthier and more productive corporations. Despite its reduction towards the average for the euro area, the outstanding stock of private debt is still high in Spain, especially for households.

Graph 2.3: NIIP by financial instruments



Source: BdE, own calculations.

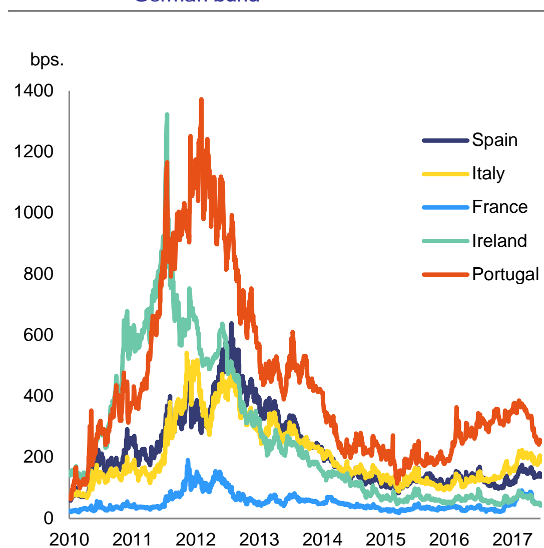
14. The still high overall level of debt is reflected in a large, though declining, amount of net external liabilities. Spain's net international investment position (NIIP) improved in 2016, by 5.7 pps, to -85.7% of GDP. Despite this correction, the net debtor position of Spain remains high. Over two thirds of the total liabilities – or 167.5% of GDP - is represented by callable liabilities instruments (see Graph 2.3). Although much of the debt has long-term maturity and does not pose an immediate risk in terms of liquidity,([14]) it 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.

2.2. FINANCIAL SECTOR DEVELOPMENTS

15. Despite several episodes of volatility on the international markets, Spain's financial sector indicators remained resilient to external developments. After a bank share slump in early 2016 and following the results of the UK referendum in June and of the US elections in November, the share prices of most Spanish banks bounced back and almost returned to their end-2015 levels. At the same time, the Spanish government bond yields and spreads have moderately increased. In May 2017, the Spanish 10-year government bond yield fluctuated in the 1.6-1.8% range, and its spread over the German Bund was at about 140 basis points, around 20 points higher than in November 2016 (see Graph 2.4). Although the 5-year Spanish CDS spreads spiked by around 30 basis points immediately after the UK referendum, they declined afterwards and stabilised at around 60 points through the second part of 2016 and around 40 points in the first quarter of 2017. They decreased by an additional 10 points in May 2017.

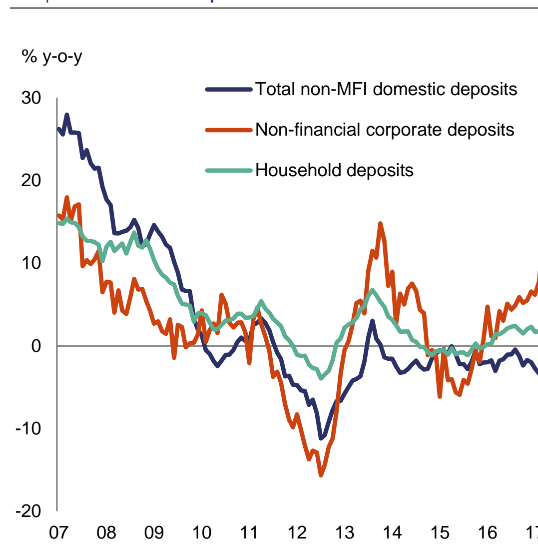
([14]) In addition, Banco de España external debt (net Target-2 liabilities) that is not subject to refinancing risk amounted to 34.8% of GDP in 2016.

Graph 2.4: **Euro area sovereign spreads to the 10-year German bund**



Source: IHS Markit, own calculations.

Graph 2.5: **Bank deposits**



Source: BDE.

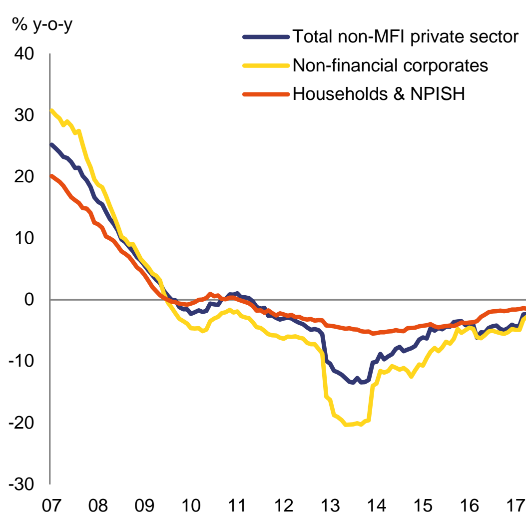
16. While access to ECB liquidity remains ample, Spanish banks are diversifying their funding sources. Private bank deposits continued to grow, except for deposits stemming from non-monetary financial institutions, which declined somewhat. This eased further the banks' reliance on wholesale funding in the context of the overall deleveraging of balance sheets and ample access to ECB liquidity. Total deposits of households increased by almost 2% y-o-y as of February 2017. Deposits of non-financial corporations (NFCs) accelerated their annual growth rate to 7.8% in parallel with the diminishing demand for large corporate loans (see Graph 2.5. While the importance of wholesale and inter-bank funding continued to decline relative to deposits, their accessibility and costs improved further. Moreover, the Spanish banks' total net borrowing from the Eurosystem decreased from its peak of EUR 389 billion in August 2012 to around EUR 142 billion in January 2017.

17. Spanish banks continued to deleverage their balance sheets but new lending to SMEs and households is growing. In March 2017, banks reduced their domestic assets further, by about 4% y-o-y, in line with the decline of the stock of domestic private credit. The stock of credit to households shrank by about 1.5% y-o-y at end-2016 – with the stock of consumer loans accelerating to almost 14% y-o-y in February 2017 and the stock of mortgage loans slowing down its pace of decline to about 3% y-o-y, backed by the recovery in the housing market. Credit to NFCs was still declining by 4.7% y-o-y in February 2017 (see Graph 2.6). However, including external borrowing and issuance of bonds, lending to NFCs increased by 0.8% y-o-y as of February 2017. ([15]) Moreover, credit to NFCs was almost flat over the last year if the construction and real estate sectors are excluded. New lending to households continued to rise in 2016 over 2015, but decelerated to single-digit growth rates after the surge in new lending that occurred in 2015. New lending to SMEs (proxied by loans under EUR 1 million) advanced by about 3% in 2016 vs. 2015. It thereby reached a monthly average of around EUR 14 billion (a value last observed in 2011). At the same time, the volume of new

([15]) 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 bank credit of NFC turned positive in March.
http://www.bde.es/webbde/es/estadis/infoest/e0806e.pdf

lending of loans over EUR 1 million declined by about one third in 2016 over 2015. This reflects an increased capacity of large enterprises to generate internal financing and improved access to capital markets. Since the launch of the ECB's corporate bond purchase programme (CSPP), large companies have increased the issuance of euro-denominated securities and have reduced their demand of bank lending. As a result, the volume of total new lending to large NFCs retreated in favour of new lending to SMEs.

Graph 2.6: 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.

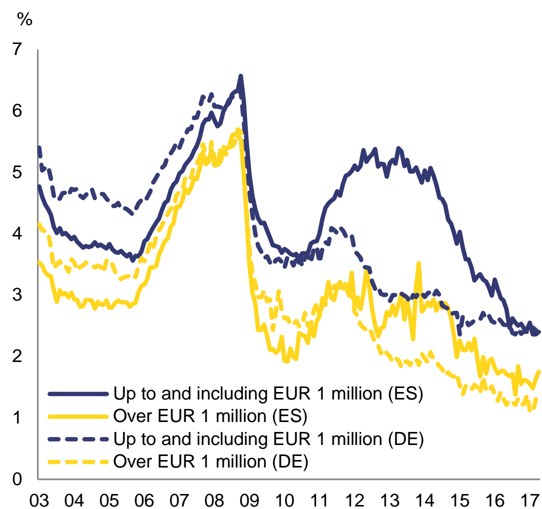
18. In the first quarter of 2017, credit standards for approving NFC's loans became stricter while they improved in the case of households. According to the BdE's Bank Lending Survey ([16]) from April 2017, margins on loans for companies remained unchanged on average but they were widened for riskier loans in the first quarter of 2017. Margins on mortgage loans were broadly narrowed, with the exception of riskier loans for which they were widened. In the first quarter of 2017, the upswing in credit demand materialised. Credit standards for approving NFCs' loans were tightened in the first quarter of 2017 compared to the last quarter of 2016. They were further eased for households' consumer credit and remained unchanged for households' mortgage loans.

19. Access to finance and availability of bank credit is not considered an important problem by SMEs in Spain and in the euro area anymore. In the latest round of the SAFE survey ([17]) (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% 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. Euro area SMEs reported a continued increase in the availability of bank financing and in the willingness of banks to provide credit at lower interest rates. 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 end-2015 to March 2017 by 63 bps, to 2.36%. Thus, for the first time since 2009, it fell below the interest rate charged for similar loans in Germany (2.43 % in March 2017).

([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/stats/money/surveys/sme/html/index.en.html

Graph 2.7: Cost of borrowing for NFCs



Source: ECB

20. On aggregate, Spanish banks continued to reduce their NPLs in the second half of 2016 and the first quarter of 2017. Following the continued work-out of such loans by banks, against positive economic growth over the past year, the stock of NPLs fell by approximately EUR 17 billion y-o-y until March 2017, corresponding to a 13% reduction of the stock. This was due both to disposals and write-offs, as well as to cured loans. Meanwhile, the total loan volume to NFCs and households decreased by about EUR 27 billion over the same period. As a result, the share of NPLs in total loans (NPL ratio) dropped from 10% in March 2016 to 8.8% one year later (see Graph 2.8). 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 from about 28% to 26% last year. Although they were reduced only modestly, NPLs for household loans displayed the lowest ratio to total loans of about 5.5% at end 2016. The average NPL ratio on the foreign operations of Spanish banks is below 5% on average, and thus much lower than for the domestic activity. According to data by the EBA for the first half of 2016([18]), the aggregate NPL ratio ([19]) of Spanish banks was only slightly above the EU median.

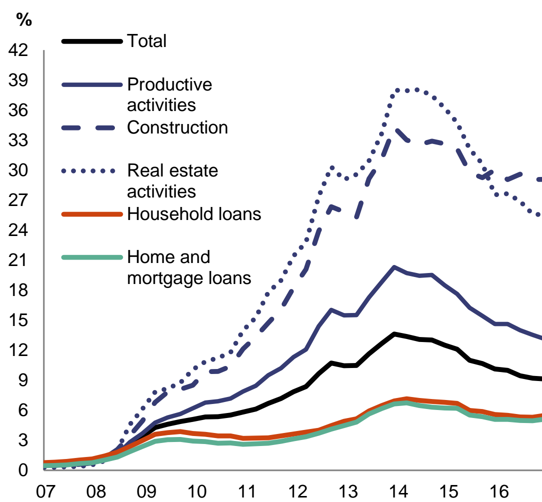
21. Banks further reduced forborne and foreclosed assets in 2016. Forborne loans continued declining, by around 32% y-o-y to EUR 147 billion at consolidated sector level. As in 2015, sales of existing foreclosed assets (amounting nearly 15% of the stock of foreclosures at the end of 2015), exceeded additions of new foreclosures (around 12.3% of the stock).

22. Restructuring of the banking sector has gone beyond state-aided banks. The entire Spanish banking sector has since the crisis significantly adjusted its business model and lowered cost basis, especially by reducing the branch network and the number of staff by around one third each.

([18]) EBA (2016), Risk Assessment of the European Banking System, December.

([19]) The EBA (2016) study relies on the harmonised European definition of NPLs for supervisory purposes (under FINREP) at the highest level of consolidation. The denominator of the ratio only covers exposures qualifying as loans, thus excluding debt securities or off-balance sheet exposures. Due to differences in scope and definition, the EBA figures tend to differ from the figures provided by BdE.

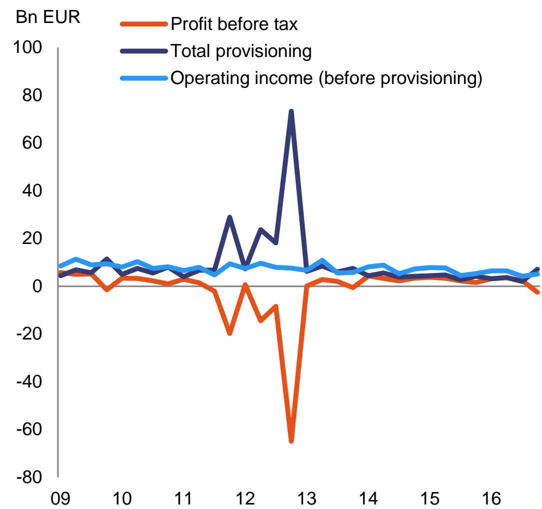
Graph 2.8: Non-performing loans



(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. In 2016, profits of Spanish banks continued to be squeezed by very low interest rates, slow lending activity and further provisioning. Banks' net interest income declined by 8% from 2015 to 2016, and operating income by 13%, or EUR 3.3 billion, as banks' operating costs remained nearly constant. As in 2015, the total provisions built by the banks remained at a similar and relatively high level of close to EUR 16 billion representing more than 70% of the banks' net operating income. This shows that the process of balance-sheet clean-up is rather lengthy and costly (see Graph 2.9). As a result, the profit before tax shrunk by about EUR 3 billion or 30% from 2015 to 2016. During the last quarter of 2016, the aggregate financial results of Spanish banks on domestic operations were negative – but positive during the whole year -, due to the substantial impact of the provisions recorded by a mid-sized bank and following some changes to the bank accounting regime by BdE. Gross consolidated profits, including foreign operations, decreased by about 20% in 2016 to less than EUR 11 billion. A 4.3% return on equity was recorded which was somewhat higher than the EU average. Also in terms of cost-to-income ratio Spanish banks do relatively well compared to their EU peers.

Graph 2.9: Bank sector profitability



Source: BdE, own calculations.

24. On average, Spanish banks further strengthened their capital positions in 2016. The average common equity tier 1 ratio rose by 16 bps to 12.8% as of December 2016. This is well above the regulatory and supervisory minima. The total solvency ratio also strengthened by a similar amount of basis points in annual terms. The main driver of the higher capital levels 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. The reduction of credit portfolios has also contributed to the increase in capital ratios**.** Nevertheless, despite being on a declining trend, NPLs are still high and represent a burden. Some smaller banks still need to reinforce their balance sheets.

25. On 7 June 2017, Banco Popular was resolved following difficulties linked to a significant portfolio of legacy real estate assets and rapidly deteriorating liquidity. Banco Popular emerged from the "adverse" scenario of the 2016 European Banking Authority (EBA) stress tests in a relatively weak position, prompting it to issue capital in the amount of EUR 2.5 billion at the end of June 2016. On 6 June 2017, the ECB decided that Banco Popular was "failing or likely to fail" due to a significant deterioration of its liquidity position therefore triggering action by the SRB. The SRB adopted a resolution scheme

entailing the sale of Banco Popular to Banco Santander for the price of EUR 1. The purpose of this operation was to ensure continuity of the bank's business activities, including full access by customers to deposits, and to avoid adverse effects on financial stability. The SRB decided to write-down and convert all capital instruments of Banco Popular prior to the transfer of assets to Santander in order to address the shortfall in the value of the institution. Hence, the implemented resolution ensured full protection of deposit holders and avoided the use of tax payers' money.

3. FINANCIAL SECTOR RESTRUCTURING AND REFORM

3.1. PROGRESS WITH BANK RESTRUCTURING

26. 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. As regards the required divestments of subsidiaries, banks are mostly on track, 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 restructuring period.

27. 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.

28. Bank re-privatisation started in 2014 but has stalled since then. 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 re-privatisation of Bankia, by selling on the market 7.5% of the shares held in Bankia by BFA. Since then, no further privatisation of parts of Bankia has been carried out due to rather weak bank equity market conditions and political uncertainty. Earlier this year, FROB gave green light for the merger of state-owned Bankia and BMN with the intention of progressing with their privatisation. In the meantime, however, the deadline for the divestments of public stakes in Bankia and BMN has been extended by two years (to 2019) through a Royal Decree Law (RDL 4/2016) issued by the government at the end of last year. The government considers the two-year extension warranted to ensure the most efficient use of public funds.

29. Bankia's legal contingencies regarding an initial public offering (IPO) in 2011 and the sale of hybrid instruments are contained. Following the adverse rulings by the Spanish Supreme Court on the existence of accounting errors for its 2011 IPO, Bankia decided to compensate all retail investors that bought shares into it. Bankia and its holding company, BFA, agreed to share any losses from civil lawsuits or the voluntary compensations provided that the sharing does not result in further State aid. The full amount of the retail tranche of the IPO (EUR 1.84 billion) is already fully provisioned by BFA/Bankia. Similarly, Bankia has sufficient provisions for losses regarding hybrid instruments to retail investors, which may be increased if necessary.

3.2. SAREB – RECENT DEVELOPMENTS AND OUTLOOK

30. SAREB's provisional results for 2016 show continued divestment of its portfolio but do not point to an improvement of its financial results. Since its inception, SAREB achieved a 21% reduction of its portfolio to EUR 39.7 billion and amortised EUR 9.8 billion of senior debt. An active conversion of loans into real-estate units (REOs) took place with the latter representing now 33% of the portfolio from 22% originally. Notwithstanding the overall success of SAREB in contributing to the stabilisation of the Spanish banking sector over the past years, it continues to make sizeable losses despite the ongoing stabilisation of the real estate market. SAREB posted another pre-tax loss of EUR 663 million in 2016. Following the change in accounting standards stipulated by Royal Decree Law 4/2016, which eliminated the impact of the asset impairments resulting from valuing SAREB's portfolio on the P&L account, the cumulated losses of the company over 2012-2016 were restated and reduced to EUR 750 million. In parallel, SAREB's capital buffers were restored to EUR 4 billion at end-2016 as the former asset impairments were recorded as reserves included in capital. At the same time, RDL 4/2016 maintained the transparency of mark-to-market SAREB's portfolio

introduced by the BdE Circular 5/2015. As a result, an adjustment to equity in amount of EUR 3.4 billion was recorded at end-2016 in order to provision for mark-to-market losses. It is worth mentioning that SAREB's real estate assets (REO) portfolio displayed EUR 1.5 billion of potential gains that were not off-set against the losses of the loan portfolio according to the current valuation rules for SAREB's assets.

31. SAREB's revenues in 2016 were at about the same level as in 2015, i.e. EUR 3.9 billion, but 24% lower than the peak revenues recorded in 2014. Nevertheless, the completion of the migration to four new servicers facilitated a higher number of divested assets in 2016, which increased by 25% over 2015. At the same time, SAREB increased the number of asset sales incurring capital losses in 2016, so that its gross margin amounted to only EUR 664 million or 46% lower y-o-y. This has heavily impacted the financial results for the year which ended with an almost equal pre-tax loss of EUR 663.

32. Several factors contributed to the so far negative financial results of SAREB. The most important ones are the slower than expected recovery of real estate prices, an underestimation at SAREB's inception of the costs of carrying its portfolio, the difficulty to value accurately the transferred assets and the cost of interest rate hedging. The slower divestment of SAREB's portfolio in 2015 and 2016 relative to 2014 is due to two exceptional factors: (1) the transfer to the new portfolio servicers (which was delayed, but is now completed) and (2) the gradual transformation of loans into real estate assets (REOs). This requires a laborious process of loan restructuring, debt-for-asset swaps and use of the judicial system to foreclose assets.

33. The ongoing recovery of the Spanish real estate market may improve SAREB's financial situation. The key determinant of SAREB's financial results remains the evolution of the real estate market. From peak to bottom, average Spanish real estate prices declined by about 40%, but now they stabilised and started to grow slowly again. However, SAREB's 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

34. The Spanish authorities approved the extension of the suspension of evictions for vulnerable families. The suspension of evictions, which entered into force in 2012, was initially designed as a temporary measure. On 17 March 2017, the Government extended the suspension by three years (through Royal Decree-Law 5/2017). The prolongation was accompanied by a widening of the definition of vulnerable families.

35. The BdE has updated its macro-prudential tools to the regulatory changes enshrined in Law 10/2014. Under the G-SII identification methodology by the Basel Committee on Banking Supervision (BCBS) and the Capital Requirement Directive (CRDIV), transposed in Spain through Law 10/2014, Santander was identified among the Global Systemically Important Banks([20]). Santander therefore needs to meet a buffer of 0.5% buffer in 2017, 0.75% in 2018 and a 1% from 2019 onwards, conditional upon future annual reviews. Moreover, as regards the domestic systemic importance of the banking sector, the BdE established a capital buffer for the five largest Other Systemically Important Institutions (O-SIIs) ([21]), i.e. BBVA, Caixabank, Bankia, Sabadell and Popular([22]), in October 2016, with a gradual phase-in period**.** In application of the EBA methodology on the identification of O-SIIs (EBA/GL/2014/10) and the criteria established by the ECB to reduce heterogeneity across banks supervised by of the SSM, BBVA is expected to meet a 0.75% buffer whereas the other four banking groups are expected to meet a 0.25% buffer from 1 January 2019 onwards. This decision was adopted before the resolution scheme for Popular was approved by the Commission and the SRB. Hence, a new path for the consolidated

([20]) Based on (a) group size; (b) the interconnectedness of the group with the financial system; (c) the possibility of replacing the services or the financial infrastructure that the group provides; (d) the complexity of the group; and (e) the group's cross-border activity

([21]) Apart from the largest bank, Santander, for which the highest of the two buffers (G-SIIs and O-SIIs) is applied, in accordance with CRDIV provisions. Since the two are identical, the buffer required for Santander in 2017 will be 0.50%.

([22]) The six systemically important institutions in Spain account for around 81% of total assets of the consolidated banking sector.

Santander banking group (including Popular) may be approved in the near future. Finally, the BdE introduced the counter-cyclical buffer in December 2015 to be applied from January 2016 onwards. However, given the subdued credit dynamics, BdE continued to set the quarterly buffer rate at 0% in March 2017.

36. The lending activity of the Instituto de Credito Oficial (ICO) played an important counter-cyclical role during the crisis, but has recently slowed down significantly. As bank lending to SMEs picked up in the aftermath of the crisis, ICO's provision of new credit to the economy decreased significantly. New credits through the so-called second-floor facilities declined from a stock of about EUR 16 billion in 2014 to around EUR 5 billion in 2016. At present, ICO is focusing on providing export facilities (internationalisation of the economy), boosting its AXIS subsidiary for venture capital, contributing to the Investment Plan for Europe, and promoting the development of securitisation of SME lending portfolios. Thus ICO is increasing its financial agent role, managing funds on behalf of others. ICO has enhanced the activity of "Axis" that manages several private equity funds that aim at promoting the venture capital industry in Spain, supporting the expansion of start-ups and mid-caps and financing infrastructure projects. The largest of these funds – the Fond-ICO Global – is a fund of funds. It has been granting funding to private funds that are selected through a recurrent public tendering process since 2013. An eighth tender has been launched in December 2016, bringing the total approved funds to 48, with financing commitments of up to EUR 1.1 billion.

37. In addition to ICO's activity, other initiatives were pursued to strengthen non-bank financial intermediation. The Ministry of Finance's Compañía Española de Reafianzamiento (CERSA) vehicle, which acts as a guarantor of Spain's regional public guarantees offered to Spanish SMEs, has grown substantially in recent years. In February 2016, the European Investment Fund (EIF) entered into a new agreement to provide CERSA counter-guarantees, benefiting from support of the EFSI as part of the Investment Plan for Europe. The new agreement facilitated the leveraging of additional loans of about EUR 1.7 billion in 2016, more than doubling CERSA's guaranteed loan portfolio. The integration of CERSA funds by mergers advanced, and the mutual guarantee companies were consolidated from 23 to 18, thereby increasing the reliability of their services. 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 2016; the total outstanding balances of its listed instruments almost doubled to about EUR 2 billion at end-2016. In October 2016, Title I of the Law 5/2015 regarding the SME Financial Information report to be provided by banks and the Circular of Bank of Spain that develops it entered into force. Thus, banks must notify SMEs three months in advance of their intention to terminate a certain financing agreement and provide SMEs with their financial and credit risk information track record.

38. A Royal Decree recently adopted by the government delays the full implementation of the savings banks' reform. The reform of the saving banks' sector is one of the key pillars of the financial assistance programme. Its rationale is to set incentives to reduce controlling stakes of banking foundations in banks by imposing additional costs on them. The last legal step of the reform - BdE Circular 6/2015 approved in November 2015 - establishes additional obligations for banking foundations that hold a controlling stake in a bank. The Royal Decree 536/2017 adopted by the government on 26 May 2017 weakens some of these obligations. It reduces the proportion of cash dividends received by the banking foundations that have to be allocated to the reserve fund, from 50% to 30%. It also extends the time period for generating reserve funds, from the initial five (plus two additional years where justified) to eight years (plus one additional year). These amendments reduce the incentives for banking foundations to divest controlling stakes in former saving banks.

39. The resolution action taken with respect to Banco Popular is the first adopted by the SRB and signals that the EU resolution framework created in the aftermath of the last financial crisis works properly. Progress continues as regards the participation of Spain in the SRB. Under the framework of the internal resolution teams for the banking groups, the Spanish authorities continued to draft resolution plans to be endorsed by the SRB. BdE is making progress in

discussing with the banks the concrete content of the required resolution plans as well as identifying the main challenges ahead. The resolution decision of Banco Popular allowed to ensure the continuity of the important functions performed by the bank and to avoid significant adverse effects on financial stability. The sale was subject to normal merger and regulatory review and losses were fully absorbed by shares and subordinated debt and did not entail any State aid nor aid from the Single Resolution Fund.

4. CHALLENGES AHEAD FOR THE FINANCIAL SECTOR

40. Like in the case of their European peers, profitability remains squeezed for the Spanish banks. The main contributors appear to be the low interest rate environment, combined with declining volumes of business, an increase in legal costs and the still high although declining level of NPLs. In addition, banks are vulnerable to a potential correction in the price of financial assets associated with a downward revision of growth expectations and the increase of long term interest rates. Furthermore, as banks intensify competition for new business, credit standards may be weakened, resulting in the possible mispricing of risk on some credit portfolios. Such temptations which resemble some of the pre-crisis loan origination practices should be avoided.

41. While on average NPLs have continued to decline, the burden of legacy real estate assets remains high in some banks. The downward trend in the NPL ratio has continued for the aggregate banking sector. However, dispersion between banking groups and institutions is significant. In this regard, and given the sluggish recovery on net interest margins, profitability in some banks is suffering additional pressure.

42. Recent court rulings add to the pressure on the banks' already challenged profitability. The European Court of Justice ruled on the Spanish mortgage floor clauses. As a result, banks will have to pay back substantial amounts to consumers who had variable-interest mortgages with floor clauses. Since there are still legal steps to be taken before the payments become effective, and the fact that they will be extended over time may mitigate their impact on banks' balance sheets. Although the affected banks had built up provisions for litigation risks, which have already impacted their profitability, the cost of consumers' compensation needs to be closely monitored. In response, the government recently approved the creation of a monitoring commission.

43. Bank reprivatisation is proceeding slowly. The Spanish authorities are expected to make progress with the divestment of public stakes in Bankia and BMN. The Commission continues monitoring the implementation of both Bankia's and BMN's restructuring plans, even though the deadline for the divestment of FROB from these two banks has been extended from 2017 to 2019. More recently, a Royal Decree recently adopted by the government delays the implementation of the savings banks' reform, by reducing the incentives for banking foundations to divest controlling stakes in former saving banks.

44. The effective implementation of Banco Popular's transfer to Banco Santander needs to be closely monitored. Supervisory authorities will have to monitor the effective implementation of the acquisition of Popular by Santander and closely follow any risk derived from potential litigation costs.

45. SAREB faces serious challenges to finalise the divestment of its portfolio in a profitable manner. SAREB made further progress to optimise its operations which culminated with the finalisation of migrating the asset portfolio to the new servicers. Nevertheless, it still has to better adapt its IT infrastructure to its business model, strengthen internal control systems and attract new talent as staff. Most importantly, SAREB needs to monitor very well its servicers and develop innovative selling channels that would allow it to mitigate the slower than expected recovery of real-estate prices. Finally, operational costs, and in particular the costs of managing, marketing and maintaining its gradually increasing portfolio of real estate assets, will have to be well managed.

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)
Core indicators												
GDP growth rate	3.6	3.7	3.2	- 3.6	0.0	- 1.0	- 2.9	- 1.7	1.4	3.2	3.2	2.8
of which domestic demand incl. stocks	4.1	4.3	3.7	- 6.4	- 0.5	- 3.1	- 5.1	- 3.2	1.9	3.3	2.8	2.3
Private consumption (annual % change)	3.3	3.5	2.6	- 3.6	0.3	- 2.4	- 3.5	- 3.1	1.6	2.9	3.2	2.5
Public consumption (annual % change)	2.7	4.7	5.7	4.1	1.5	- 0.3	- 4.7	- 2.1	- 0.3	2.0	0.8	0.9
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
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	17.6
Gross fixed capital formation (% of GDP)	22.9	27.0	30.3	24.3	23.0	21.5	19.8	18.8	19.1	19.7	19.9	20.2
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	22.3	22.3
General Government (% of GDP)												
Balance (g)	- 4.1	- 0.5	0.2	- 11.0	- 9.4	- 9.6	- 10.5	- 7.0	- 6.0	- 5.1	- 4.5	- 3.2
Gross debt	63.0	51.3	39.1	52.8	60.1	69.5	85.7	95.5	100.4	99.8	99.4	99.2
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
Households												
Households saving rate	12.8	10.8	7.8	13.4	10.1	10.8	8.6	9.6	9.0	8.2	7.7	7.2
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	2.4	2.9	2.7
Trade balance, goods	- 3.6	- 5.8	- 8.2	- 3.8	- 4.4	- 4.2	- 2.8	- 1.4	- 2.2	- 2.0	- 1.6	- 1.9
Trade balance, services	2.9	3.1	2.7	2.7	3.1	3.9	4.3	4.6	4.6	4.5	4.5	4.7
Current account balance	- 1.4	- 4.3	- 8.9	- 4.3	- 3.9	- 3.3	- 0.4	1.5	1.0	1.3	1.9	1.6
Net financial assets	- 27.7	- 42.0	- 70.2	- 90.2	- 85.4	- 90.2	- 91.8	- 92.1	- 95.2	- 90.4	- 85.2	n.a.
Net international investment position (h)	- 28.8	- 44.3	- 71.6	- 93.5	- 88.6	- 91.9	- 89.9	- 94.3	- 97.5	- 91.3	- 85.7	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	93.9	92.3	91.5	91.7	90.5	89.8
Real effective exchange rate relative to the rest of the European Union	88.6	90.1	98.4	102.3	100.0	98.5	93.5	92.5	91.4	90.4	90.3	90.0
Real effective exchange rate relative to the rest of 37 industrialised countries	87.4	88.1	99.7	104.1	100.0	98.6	92.5	93.1	92.4	89.2	88.6	87.7
Banking sector												
Assets (% of GDP)	170.8	189.9	267.9	319.4	321.1	338.3	344.4	307.3	286.7	263.0	244.9	232.2
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	- 2.3
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	8.8
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.
" 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.
" 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.
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.
Tier 1 ratio (%)	n.a.	n.a.	n.a.	9.3	9.6	10.2	9.7	11.7	11.7	12.6	13.1	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	1.5
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

Updated on 09 Jun 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, Eurostat, IHS Markit

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