GDP
3.2%

INFLATION
0%

HOUSE PRICES
+1.8%

MORTGAGES ARRANGED
+19.8%

NEW CREDIT
€467.93 BN

JOB CREATION (EPA)
525,100

ECONOMIC, FINANCIAL AND REGULATORY ENVIRONMENT

The economic context in 2015 was dominated by the intense decline in commodity prices, fears of a hard landing in China and outflows of capital from emerging economies. There was also a change of cycle in US monetary policy in December and the Federal Reserve raised interest rates for the first time in almost 10 years.

In this context, the performance of the main economies and regions was unevenly distributed. On the one hand, net commodity-exporting economies, mostly in emerging economies in Latin America and Asia, suffered inflationary pressures, resulting from a substantial depreciation of their currencies, a tightening of financial conditions and a notable weakening of economic activity (as was the case in Brazil, for example). On the other hand, the rest of the economies, in general, registered very low inflation rates. A number found some traction, as is the case of the main developed economies. Other economies, most net commodity-importing emerging economies, including China, maintained fairly robust growth.

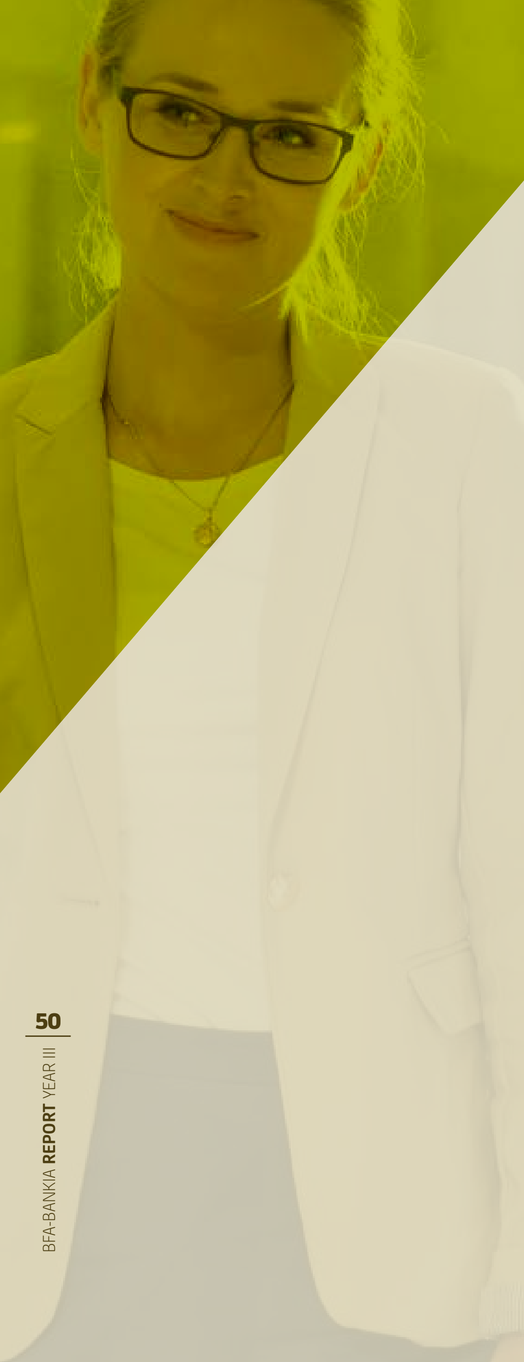
On balance, the world economy once again experienced a somewhat disappointing performance in 2015. Global growth was just 2.6%, slipping from the 2.7% reached in 2014, and well below the rates above 4% posted prior to the financial crisis.

The highlight regarding the main central banks was the confirmation of the diverging trends of their monetary policies. The European Central Bank (ECB) expanded the asset purchase programme it started in the last quarter of 2014 to include debt from sovereigns, agencies and local and regional governments, extending its target volume to 60 billion euros per month until March 2017. It also increased the cost to banks of holding their surplus liquidity at the ECB by dropping the deposit facility rate from -0.20% to -0.30%, pushing rates along the whole Euribor curve into negative territory, with the exception of the 12-month rate, which moved close to zero.

Meanwhile, the Fed initiated the cycle of interest rate hikes by increasing its target range to 0.25%-0.50%. In any case, thanks to the central banks' cautious attitude and the sharp fall in the oil price, which has reduced inflation, the year-end level of government debt was better than expected at the start of the year, with generally very modest increases in yield.

Spain's risk premium reached a high of 160 bp in the summer, due to the Greek crisis (there were even fears Greece might leave the euro). It then fell to levels at the start of the year (around 100 bp) before rising once more to 120 bp at year-end due to uncertainties about the outcome of the general elections.

Forecasts for 2016 are relatively optimistic, although the macroeconomic situation is set to remain flat rather than improve. World economic growth is only expected to rise slightly year on year with the expected quickening of growth in Europe and Japan being



offset by lower growth in the US. Excessively low inflation will persist in the leading developed economies. The divergence between the monetary policies of the Federal Reserve and the ECB will remain in 2016 and will be one of the most influential factors shaping the financial markets. The Fed will continue to normalise its interest rates throughout 2016: we expect that it will raise rates by 0.25% at alternate meetings to between 1.25% and 1.50% at year end. The ECB, meanwhile, will continue to expand its balance sheet and it cannot be ruled out that it will not cut its deposit rate still further, although this is not the most likely scenario.

SPANISH ECONOMY

In 2015 the Spanish economy continued the recovery, registering the fastest GDP growth in eight years (+3.2% vs +1.4% the previous year), putting it in the spotlight as one of the fastest growing economies in the eurozone.

The drivers of this growth included both internal and external expansionary stimuli. On the one hand, cheaper oil, depreciation of the euro, reactivation of the European economies, and the ECB's QE programme had a positive impact on the incomes and expectations of households and businesses. In Spain, the intensity of fiscal consolidation

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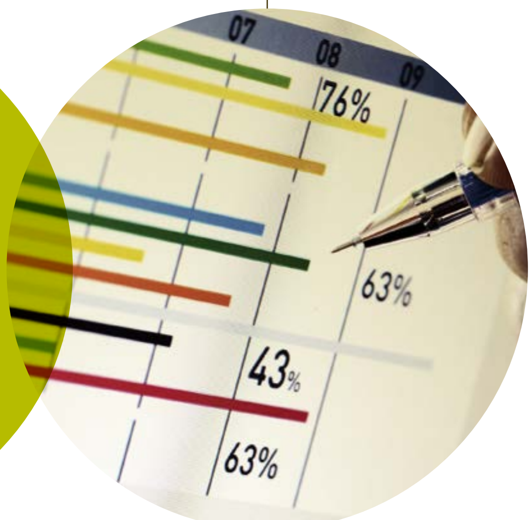

HOUSING
MARKET TRANSACTIONS

350,000

dropped somewhat, personal income tax was cut, the focus of manufacturing shifted towards exports, and the reforms and progress made in redressing the internal imbalances and boosting competitiveness created the right conditions for a faster recovery.

That said, the progressive decline in global growth forecasts, primarily in emerging economies, and a certain dampening of some cyclical drivers caused the quarterly GDP growth rate to wane over the course of the year from an extraordinary 1% on average during the first six months to 0.8% at the back end of the year.

Domestic demand not only continued to be the driving force of the economy but also gained importance during the year, making the greatest contribution to GDP growth since 2007 thanks to buoyant investments and above all household spending.

In line with the upswing in demand, better credit terms and the need to renew the capital stock used in production, investment in capital goods rose sharply. The dramatic slump in construction during the crisis also came to an end with the sector posting its first positive figure in eight years. Household spending was fuelled by an uptick in disposable income as many jobs were created, taxes were cut and inflation fell to extreme lows. External demand continued to drag down GDP growth because of the sharp increase in imports due to the high levels of domestic expenditure. This was partially offset by exports, driven by the upturn in European economies and improved competitiveness.

The housing market continued to build on the positive figures posted in 2014. House sales (rising to 350,000), mortgages, prices and even new housing permits rose sharply from all-time lows. The widespread increase in economic activity, job creation and more relaxed borrowing conditions underpinned a gradual recovery in domestic demand, which added to the uptick in external demand.

The upswing in domestic saving – reaching the highest level since 2007, made the dynamism of investments compatible with a significant increase in financing capacity in the economy.

Inflation remained in negative territory for much of the year, and after the knock-on effect of the intense slump in oil prices at the end of 2014, inflation closed the year positive, albeit very low. This rise in inflation also sparked domestic demand and euro depreciation.

The outlook for 2016 is that the expansionary phase will continue, although at a somewhat more sedate pace. We therefore forecast that GDP will grow by around 2.8%. In any event, one cannot rule out the risks and uncertainties fuelling a downturn such as the performance of some emerging economies and of the commodities and financial asset markets. High levels of debt continue to make the Spanish economy more vulnerable and highly dependent on foreign finance.

BANKING BUSINESS AND REGULATIONS

The growth of the national economy has continued to drive the recovery of the banking sector. The increased financing needs of Spanish businesses and households have been met by a boost in new lending by banks under very favourable conditions, allowing the total volume of private sector lending to continue to recover and probably rise next year for the first time since 2009. A contributing factor has been the improvement in asset quality, as reflected in the fall in the NPL ratio, bringing the cost of risk back towards normal levels.

Even so, the pressure on profits has become more severe. On the one hand, the very low interest rate environment has pushed the interest rate spread down to record low levels, eroding the basic margins of the banking business. On the other hand, 2015 was marked by various regulatory and supervisory milestones that have significantly affected banks' strategy and performance.

In the eurozone, 2015 was a key year in the constitution of the Banking Union: the European initiative designed to protect the euro's integrity, breaking the vicious circle between banking risk and sovereign risk, enhancing prevention and management of banking crises and spurring market integration. 2015 was the first full year of the Single Supervisory Mechanism: the first pillar of the Banking Union which puts direct supervision for more than 80% of the sector's assets in the hands of the European Central Bank.

With regard to crisis management, the Single Resolution Mechanism (the second pillar of the project) also became operational in 2015, except for the bail-in functions, which come into force in January 2016 along with the gradual introduction of the Single Resolution Fund. The new bail-in instruments will extend banks' capacity to absorb losses to all unsecured debt. A new requirement for own funds and debt has been introduced to ensure this is effective. Known as the Minimum Requirement for Own Funds and Eligible Liabilities (MREL), this is applicable on an individual basis and will gradually be imposed on all European credit institutions as from 2016.

The single deposit guarantee fund (the third and last pillar of the Banking Union) is taking longer to set up. At the end of 2015, the European Commission approved a preliminary proposal, which it is expected will continue to be hotly debated.

At a world level, work on crisis management for systemic banks has progressed. In November, the Financial Stability Board approved the final version of the TLAC (Total Loss-Absorbing Capacity) ratio which is in line with the MREL. It will be a standard ratio applicable to globally systemic important banks only as from 2019.

Work continued in Spain last year to adapt legislation to European regulations. In June, the Bank Recovery and Resolution Directive was transposed in Spanish law, although some doubts remain as to the bail-in hierarchy. Moreover, to ensure the treatment of banks' deferred tax assets is compatible with European rules on state aid, the Spanish government approved an amendment to the Corporations Act with the consent of the European Union and the ECB. This adjustment guarantees the stability of the calculation of regulatory capital for Spanish banks.

All these rules are a step towards a banking system that is better prepared to deal with the new challenges ahead and more resilient to future crises. The positive results of the European Banking Authority's last transparency exercise published in November are proof of this, showing that the banking system is more robust and underpinned by a greater capital cushion.

GDP GROWTH FORECAST FOR 2016

2.8%

2015 WAS A CRUCIAL MILESTONE IN THE CONSTRUCTION OF THE BANKING UNION: THE EUROPEAN PROJECT DESIGNED TO SECURE THE EURO'S FUTURE