02.1 ECONOMIC, FINANCIAL AND REGULATORY ENVIRONMENT.

IN 2016 THE BANKING BUSINESS WAS CONDUCTED IN A DIFFICULT ENVIRONMENT, MARKED BY INSTABILITY AT THE GLOBAL LEVEL AND CONTINUING VERY LOW INTEREST RATES, UNDERMINING PROFITABILITY. THE SPANISH ECONOMY, HOWEVER, PERFORMED SURPRISINGLY WELL.

The economic recovery once again proved remarkably resilient in 2016, riding out major political shocks, including Brexit, the Trump victory in the U.S. presidential elections and the increased instability in Italy following the "no" vote in the referendum on constitutional reform that led to the resignation of the prime minister. Despite these adverse factors and the weakness of the U.S. economy during the first half of the year, world growth was on a par with 2015 (estimated at 2.5%). In the euro area, growth was above potential but moderate (1.7%), with significant differences between the main countries: 1.8% in Germany, compared to around 1.0% in France and Italy.

Inflation sentiment also changed substantially over the year. Inflation fears persisted throughout much of the first half, but gradually inflation started on an upward trend, thanks to the recovery of the oil price, which ended the year above 50 dollars per barrel, after hitting a low of 27 dollars in January. In November, Trump's victory gave an additional upward boost to inflation forecasts, as the markets discounted expectations of a strong fiscal stimulus in the U.S. that would revive global demand.

The main monetary policy event was in March, when the ECB reacted to the low inflation in the euro area by cutting its reference rates (the repo rate from 0.05% to 0% and the deposit facility rate from -0.30% to -0.40%), increasing the volume of its asset purchase programme and expanding the programme to include the bonds of private-sector non-financial companies. The ECB also announced a new liquidity programme for banks, subject to meeting certain targets for credit to the private sector. Similarly, in August, following the Brexit vote, the Bank of England strengthened its expansionary policy, reactivating the quantitative easing programme and lowering its interest rate from 0.50% to 0.25%.

These actions drove interbank market interest rates to new record low levels, with the one-year Euribor slipping into negative territory. Sovereign yields also remained at

very low levels, with the 10-year German bond reaching 0.20. The situation changed in September, when prospects of a tapering of monetary stimulus measures by the ECB and the Bank of Japan and a rise in inflation forecasts, especially following Trump's election victory, prompted a sharp rise in yields, which created expectations of a change in the long-term trend.

THE SPANISH ECONOMY

The Spanish economy performed surprisingly well in 2016, with GDP growth of 3.2%, a better pace than forecast at the beginning of the year. This third consecutive year of growth, on a par with 2015, put Spain back among the fastest-growing of the large developed economies.. At the same time, strong job creation (with 414,000 more people in employment, according to the Economically Active Population Survey (EAPS)) brought the unemployment rate down to 18.6%, its lowest level since 2009. Even so, despite the spurt in economic activity over the last three years, growth is not yet back at pre-crisis levels, neither in terms of GDP (still 1.2% lower) nor, above all, in terms of employment, as there are still two million fewer people in work, according to the EAPS.

GDP GROWTH
3.2%

The vigour of the economy is attributable to strong expansionary stimuli, including the positive impact of low oil prices (which was more pronounced in Spain than in other European countries, given Spain's greater energy dependence), favourable funding conditions and the easing of fiscal consolidation. Added to this was the buoyancy of the tourism industry, which ended the year with record figures, thanks to increased geopolitical risk in rival destinations and the release of a substantial volume of pent-up spending, after the long-drawn-out crisis. The climate of political uncertainty arising from the extended period of caretaker government had no noticeable impact on risks.

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ECONOMIC, FINANCIAL AND REGULATORY ENVIRONMENT.

Domestic demand continued to be the engine of the economy, fuelled above all by household spending and corporate investment. For households, the impact of wage moderation was offset by the improvement in disposable income, in a context of positive labour market performance, decline in interest payments and tax reduction. For companies, high financing capacity made it possible to maintain high rates of capital investment and so meet the surge in demand and continue to improve the stock of productive assets. After good growth in 2015, investment in construction slowed markedly, due to the slowdown in the non-residential segment, consisting essentially of public investment. Meanwhile, the housing market recovery intensified: the fundamentals of demand continued to improve, keeping pace with labour market performance and the easing of financing conditions.

For the first time in three years, external demand was no impediment to growth: while imports suffered from slack domestic demand, exports remained strong.
Unlike in other cyclical expansionary phases, a high rate of economic growth is proving compatible with the correction of imbalances. On the one hand, the improvement in competitiveness, arising from the adjustment of internal prices and costs, together with internationalisation efforts and expansion of the export base, helped to improve the trade balance, assisted by the reduction in the

2%

GDP current
account surplus.

1.6%

Inflation
with an annual average of -0.2%.

2.5%

GDP growth
forecasted for 2017.

Lending to households and non-financial companies continued to fall, though at more moderate rates. Liquidity has ceased to be a problem in a European context of expansionary monetary measures and low or even negative interest rates.

energy bill and in net external payments: the current account surplus reached a new all-time high, 2% of GDP.

Meanwhile, the increasing financing capacity generated by the economy since the end of 2012, as a result of the strong recovery in private saving, is proving sufficient to sustain the recovery of investment and, at the same time, continue the private sector deleveraging process. Thus, in terms of GDP, private borrowing fell to 169% (figure for the third quarter of 2016), the lowest level since 2005.

Inflation, after reaching a 14-month low of -1.1% in April, started on an upward path, driven by the recovery of energy prices and the buoyancy of household spending. It thus ended the year at 1%, compared to 0% in 2015, giving an annual average of -0.3% (-0.5% the previous year).

The expectations for 2017 point to robust growth, albeit at more moderate rates, so that we estimate average GDP growth of 2.5%. On the one hand, the tailwinds that have propelled economic activity in previous years will gradually diminish. On the other, various potentially high impact risks converge, both externally (Brexit, economic and monetary policy stance in the United States, electoral calendar in Europe) and internally. In Spain, the key is uncertainty as to the ability to agree on the necessary structural reforms and, above all, as to how the fiscal adjustment that is needed in order to meet the demanding deficit target imposed by the European Commission will be implemented.

PRIVATE SECTOR DEBT

167% OF GDP

(THE LOWEST LEVEL SINCE 2005)

02.1

ECONOMIC, FINANCIAL AND REGULATORY ENVIRONMENT.

BANKING BUSINESS AND REGULATION

The macroeconomic environment and monetary policy continue to affect the performance of the Spanish banking industry, with a deleveraging process that has been more prolonged than expected. Lending to households and non-financial companies continued to fall, although at more moderate rates. Liquidity has ceased to be a problem in a European context of expansionary monetary measures and low or even negative interest rates. The reduction of borrowing and the recovery of deposits by households and non-financial companies continued to drive the decline in the loan-to-deposit ratio over the last year.

Loss-absorbing capacity was strengthened, backed by the general decline in arrears and the improvement in solvency levels, largely as a result of new regulatory and supervisory requirements. The highest quality capital of Spanish banks, measured in terms of CET1, continues to comfortably exceed the regulatory minimums. On the other hand, the upturn in economic activity made it possible to continue to reduce the volume of non-performing and refinanced assets and so improve asset quality. In loans to the resident private sector, the NPL ratio is already below two digits, although still far from the level seen at the start of the financial crisis.

Profitability continues to be the main challenge for the banking business, on account of various factors. These include, on the one hand, the pressure on margins from the very low interest rate environment, the still limited business volume (given continued private sector deleveraging) and the existence of a high level of non-performing assets. On the other, the pressure and uncertainty arising from growing regulation also play a role. As in most European countries, the profitability of Spanish banks (measured in terms of ROE) remains below the cost of equity. To offset the pressure on revenue, banks continue to focus their efforts on improving cost efficiency, as shown by the capacity reduction plans started during the year, which may even give rise to corporate transactions in the coming months. Efforts to exploit the advantages of digitisation play an active role in this quest for efficiency gains. At the same time, the competitive pressure from new players specialising in specific parts of the value chain and operating outside banking regulation has intensified.

In the regulatory sphere, the reforms driven by the G-20 following the outbreak of the financial crisis continued in 2016. At global level, progress was made towards the introduction of the TLAC (Total Loss-Absorbing Capacity) requirement for global systemically important banks, which was approved in 2015. In Europe, the move towards Banking Union brought the implementation of new developments within the crisis resolution and solvency frameworks. The bail-in provisions (burden sharing by creditors according to

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a set hierarchy) and the MREL (Minimum Requirement for own funds and Eligible Liabilities) came into force in January. The Single Resolution Mechanism also came fully into operation. As regards the solvency framework, the ECB applied, for the first time, a common supervisory assessment methodology, known as the Supervisory Review and Evaluation Process (SREP), for setting minimum capital requirements.

In July 2016, the EBA published the results of the stress tests carried out on the 51 largest banks in the European Union, covering around 70% of total banking assets. None of the six Spanish banks tested were found to have capital needs, as they all had CET1 fully loaded ratios above the regulatory minimum in the adverse scenario for 2018.

In Spain, the adaptation of domestic legislation to EU regulations continued on schedule. In April the Banco de España's accounting circular (Circular 4/2016), which lays down the accounting rules for banks, was amended to improve the criteria for the recognition of loan loss provisions, the classification of transactions, the soundness of the estimation of provisions and the proper treatment of collateral for accounting purposes. Additionally, the Banco de España has for some time been participating actively, within the Single Supervisory Mechanism, in the development of a common supervisory methodology that will incorporate best practices and be applied consistently in all the countries.