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ECONOMIC, FINANCIAL AND REGULATORY ENVIRONMENT

FINANCIAL YEAR 2017 WAS MARKED BY A RECOVERY IN BANKING ACTIVITY IN A CONTEXT OF REGULATORY PRESSURE AND LOW PROFITABILITY.

2017 was the best year for the world economy since 2011. Global growth was buoyant, at nearly 3.5%, with a significant and closely synchronised acceleration of GDP. The large developed economies outperformed expectations: the euro area grew 2.5%, the United States 2.3% and Japan 1.8%.

The strength of the European countries was especially significant because the improvement during 2017 was both quantitative and qualitative: the growth was more balanced across countries (France and Italy, which had been lagging behind, performed significantly better) and across the components of demand (the acceleration of consumption reduced dependence on the foreign sector).

The emerging economies improved too, mainly thanks to the strength of China (6.9%) and the recovery of Brazil and Russia, which exited recession.

Overall, for the first time in more than six years, all the main economies grew above their potential, reducing idle capacity and boosting global inflation, thus warding off the risk of deflation. Specifically, prices in the euro area rose 1.5% in 2017, compared to 0.2% in 2016.

The robust macroeconomic conditions were an important factor in bringing stability to the financial markets, in contrast to the occasional spikes in risk, both political (uncertainty created by the Trump administration, Brexit, political uncertainty in Catalonia and difficulties in forming a government in Germany) and geopolitical (North Korea, Islamist attacks, tensions between Iran and Saudi Arabia) during the year.

In this scenario the central banks slowly gained confidence in the sustainability of the global expansion and took steps to gradually withdraw monetary stimulus measures. The United States Federal Reserve raised its interest rate three times, to a range of 1.25%-1.50%, and started to reduce its balance sheet in October.

Meanwhile, in April the European Central Bank (ECB) slowed the monthly pace of asset purchases from 80,000 to 60,000 million and announced a further reduction, to 30,000 million euros, from January this year, although it also extended its programme until September. This decision could delay the start of interest rate rises, at least until the end of 2018 or the first quarter of 2019.

This synchronised action by the main central banks generated some upward pressure on yields, although persistently low inflation (especially in the euro area), geopolitical uncertainty and doubts as to whether the United States would be able to implement its tax reforms limited the scope for upward movement.

The 10-year Spanish bond performed well, despite the political uncertainty in Catalonia, and the risk premium held steady between 100 and 130 basis points, falling to 70-80 basis points at the start of 2018.

THE SPANISH ECONOMY REMAINED VERY DYNAMIC THROUGHOUT 2017, WITH GDP GROWTH OF ***3.1%***

SURGE IN THE SPANISH ECONOMY

The Spanish economy maintained a very dynamic pace throughout 2017, with GDP growth of 3.1%, slightly below the previous year's rate. Thus, after four years of expansion, with the economy growing at rates above 3% since 2015 and cumulative growth of 13%, Spanish GDP rose above the levels reached before the onset of the 2008-2013 financial crisis, the most serious such crisis the country has experienced in recent decades.

The buoyancy of economic activity translated into strong job creation, with 490,000 more people in work, in terms EAPS, for a total labour force approaching 19 million, the best year-end figure since 2008. This had the effect of reducing the unemployment rate to 16.5% of the labour force, its lowest level in nine years. However, the aftermath of the crisis is still apparent in employment levels, as 1.75 million jobs have still not been recovered.

The Spanish economy thus showed a high level of inertia and continued to benefit from earlier tailwinds, which have proved more lasting than initially anticipated. The favourable funding conditions, for instance (a decisive factor, given the high levels of private sector debt) persisted, while the tourism industry continued to expand, setting new records; and in particular, the favourable performance of Spain's trading partners intensified.

Against this background, the last part of the year was marked by an uncertainty shock associated with the political crisis in Catalonia, although this was counterbalanced by an improvement in the environment outside Spain.

Unlike on previous occasions, the current expansion of the Spanish economy has been more balanced and shows a more robust pattern of growth. On the one hand, all the components of demand, including consumption, investment and exports, have contributed to the growth. On the other, the improvement in the economy has shown itself to be compatible with the correction of imbalances, such as the external deficit and private debt, which in the past have tended to cut such expansions short.

On the side of internal demand, household spending has continued along the path of gentle moderation begun in mid-2015, in line with the dampening of certain factors that stimulated spending, such as tax reductions or low inflation, although others persisted, such as the positive labour market performance and the decrease in interest payments. Meanwhile, companies took advantage of their high financing capacity to continue to increase and improve the stock of productive capital while at the same time reducing their indebtedness.

Investment in construction, which the previous year was held back by the slowdown in public investment, achieved faster rates of growth, driven mainly by the residential segment.

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The housing market performed very strongly, though very unevenly across regions. Increasing demand, backed by the good employment, mortgage and tourist market performance, continued to drive prices and real estate development.

External demand once again contributed positively to GDP growth, with strong exports, partly due to the locomotive effect of the European economies, but also thanks to the constant efforts to improve the competitiveness of the productive sectors, not only through price and cost reduction but also through innovation and internationalisation.

In fact, Spain has had a current account surplus since 2013 (in 2017 the surplus amounted to nearly 2% of GDP), in contrast to the large deficits recorded before the start of the economic crisis (9.6% of GDP in 2007), which were among the highest in the world. Also, since 2012 the economy has been generating financing capacity, currently equivalent to 2% of GDP, compared to the considerable financing need it had 10 years ago, above 9% of GDP.

This financing capacity makes it possible to finance investment and at the same time continue to deleverage the private sector.

From its high point, household and corporate debt has been reduced by 21.6% (58 percentage points of GDP) to 159.9% of GDP, the lowest figure recorded in 12 years.

Inflation started the year at a four-year high (3%) but then began to gradually decline, ending the year at 1.1%, compared to 1.6% in 2016. The annual average was 2.0% (-0.2% the previous year). Despite the rapid increase in the prices of fresh food and electricity in the second half of the year as a result of the persistent drought, the inflation rate fell year-on-year due to the effect of the sharp price rises in the last part of 2016.

1.7%

Percent of GDP
current account surplus

1.1%

Inflation
averaging 2% over the year

3%

GDP growth
forecasted for 2018

For 2018 we anticipate a moderate slowing of the rate of growth, although the powerful expansionary inertia and the positive external context will favour average GDP growth in the region of 3%.

Nevertheless, this scenario remains subject to various uncertainties. The external environment could be less favourable than expected, with a greater rise in oil prices or a sharper tightening of monetary policy in the United States. It also remains to be seen how world trade will respond to the increased protectionism in the United States and the complicated Brexit negotiations.

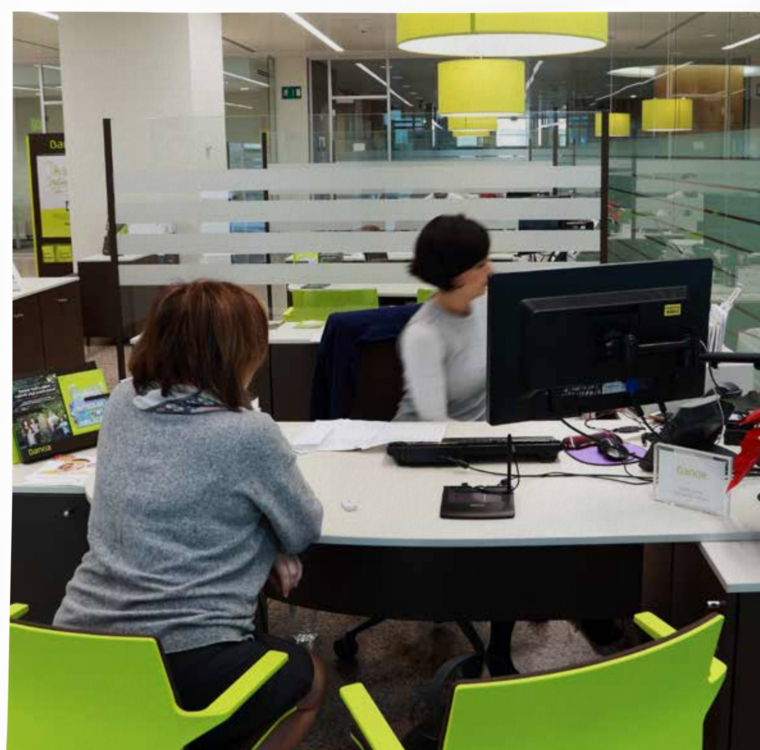
EXPECTATIONS FOR 2018 ARE FOR MORE MODERATE GROWTH, THOUGH AT RATES STILL CLOSE TO 3%.

BANKING BUSINESS AND REGULATION

In the banking arena, the year was marked by an increase in banks' financial strength and a recovery of activity, in financial and regulatory conditions that put great pressure on profitability.

Over the year, Spanish banks strengthened their balance sheets and further improved their ability to absorb shocks. Solvency indicators increased over the year, both organically and through capital increases, and remained well above regulatory requirements. Non-performing and restructured assets, on the other hand, once again declined during the year, thanks to the economic upturn, bringing the non-performing loans (NPL) ratio down by more than one percentage point, to around 8%. In June, the European authorities agreed on the resolution of Banco Popular, which was absorbed by Santander, without giving rise to any problems for system stability.

The activity of Spanish banks was supported by the buoyancy of the economy and the favourable financing conditions. New lending to households and companies gathered pace, reaching a cumulative total of more than 400,000 million euros (excluding renegotiated loans), up 11% on the previous year.



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A NEVER-ENDING PROCESS OF REGULATORY REFORM

In 2017 the process of regulatory reform continued. At the global level, implementation of the TLAC buffer (loss absorption requirement for global systemically important banks) continued, prompting a significant increase in new issue volume.

In Europe, further progress was made towards Banking Union. The European authorities reached an agreement to review the crisis resolution and solvency frameworks, in line with the reform proposed by the European Commission in November 2016. Noteworthy measures include the introduction of the TLAC in Europe and its alignment with the MREL (minimum required eligible liabilities for European systemically important banks, at an individual level), as well as the creation of a new category of loss-absorbing liabilities (non-preferred senior debt), establishing a harmonised approach within Europe. Meanwhile, the Single Resolution Board published its policy on the MREL, the highlights being that the targets will be set and notified to banks in the first quarter of 2018, will not be public and will be reviewed annually, and that the Board will set bank-specific transition periods with a maximum horizon, in principle, of four years.

In addition, transitional provisions were introduced to mitigate the impact on own funds of the new IFRS 9 accounting standard, which is intended to improve the coverage of financial instruments. Important issues remain to be resolved in order to complete the Banking Union, including the creation of a Common Deposit Guarantee Scheme (the third pillar of the process) and the establishment of a safety net for the Single Resolution Mechanism.

The progress was spread across all sectors, including SMEs, the self-employed, consumer finance and housing. However, it was not sufficient to prevent the volume of lending to companies and households as a whole from falling year-on-year, albeit more slowly, as the gradual deleveraging of certain segments of the private sector continued.

As regards customer funds, stability of deposits proved compatible with an increase in the net assets of mutual funds, largely due to higher net subscriptions. Given the decline in lending and the stability of deposits, the loan-to-deposit ratio of companies and households continued to decrease, ending the year 50% below the peak reached at the start of the financial crisis.

Profitability remained subject to the strong pressure of continuing very low interest rates. The net interest margin narrowed again last year, although lower net interest income was offset by an increase in net fee and commission income and a further reduction in operating expenses, with the result that Spanish banks continued to have one of the best efficiency ratios in the euro area, while the cost of risk returned to normal levels.

All in all, measured in terms of own funds, the profitability of the Spanish financial sector remained below the cost of capital, as in most European countries.

Over the year as a whole, stock market performance was favourable, interrupted only in October by the instability generated in Catalonia, before recovering in the last few months of the year. Banks continued to make strategic adjustments to offset the pressure on profitability, implementing cost-cutting plans and mergers and taking further steps in the digital transformation process.

As regards supervision, 2017 was the second year of application of the Supervisory Review and Evaluation Process (SREP) by the ECB. Through the SREP, the supervisor sets minimum capital requirements for significant institutions and issues Pillar 2 Guidance (P2G), a new confidential and non-binding requirement.
The ECB, one of whose top priorities is to reduce non-performing loans, also issued guidance to banks on how to manage their high volumes of non-performing loans and properly clean up their balance sheets. Similarly, the EU's Economic and Financial Affairs Council (Ecofin) proposed an action plan that includes additional measures to reduce the stock of non-performing loans, which must be adopted during the first quarter of 2018.

In Spain, the Government passed a decree law on urgent financial measures, which included two substantial changes: a reform of the legal regime governing cooperatives and the creation of a new category of loss-absorbing liabilities, "non-preferred senior debt", which will facilitate compliance with the MREL and the TLAC.