Letter from the Editors

2016 has been a difficult year for the European banking sector. Unique global market conditions, with negative interest rates, are major factors in the current difficulties. The banking industry business model is facing a shift driven by new technologies, overcapacity, a legacy of losses from the crisis and serious downward pressure on returns.

Investor perceptions of these difficulties have exacerbated valuation losses in European bank shares. These dynamics set the stage for the May SEFO´s analysis of the impact of present conditions on the European bank restructuring process, as well as our questioning of to what extent recent changes to European financial regulation may be fuelling investor concerns.

The European banking sector´s response to existing challenges has included widespread branch closures and staff cuts, although delays will likely force some entities to adopt more drastic solutions in shorter time frames. In the case of the Spanish banking sector, additional restructuring efforts will be a less traumatic continuation of a process of orderly change that began during the crisis. In general, our estimates show there are significant potential cost savings to be made from economies of scale. For the case of Spain, integration could generate cost savings of about 4%-20%. However, it is worth noting that competition is determined by rivalry and not the number of competitors or market concentration, which is set to decline further as banking moves more towards digital technologies rather than physical branches.

Apart from the fundamental pressures affecting European banks, this SEFO analyses the impact of new regulatory changes, or rather, the uncertainty surrounding their implementation, on recent losses in banks´ share value. We find that the underperformance of European banks relative to other sectors unquestionably reflects perceptions that the banking business is far more exposed than other sectors to economic weakness and interest rates. However, European bank shares have also been affected by new regulations, which substantially change the rules of the game as regards resolution regimes, as well as limits on maximum distributable amounts (MDAs) applied to financial instruments. The former change has had the most significant impact in the case of Italy, while the latter in the case of Germany. This negative impact, however, is likely more a consequence of regulatory uncertainty rather than the new measures themselves.

The May SEFO also highlights another consequence of increased regulatory requirements on financial institutions – their impact on financial disclosures. Financial institutions´ business models and products have become increasingly more complex. This has led to necessary, but more onerous, reporting obligations imposed by regulators and standard setters. Empirical evidence suggests banks´ reporting has actually become

more complex, reflecting the more challenging operating environment faced by banks. In the case of Spain, evidence suggests that financial reports were more readable and optimistic compared to the European average, although readability measures were more volatile. In general, focusing on improving readability and tone of financial reporting could represent one way to increase the clarity and transparency of quantitative financial disclosures.

Apart from financial sector issues, we look at Spain´s recent fiscal performance in an effort to deconstruct noncompliance with fiscal targets. Despite strong economic growth (3.2%), the Spanish government ran a deficit of 5.1% of GDP in 2015 (including financial sector assistance). This result implies noncompliance with both internal and EU targets, and together with increased public debt since the start of the crisis, is casting doubt on Spain's ability to restore its budgetary equilibrium and ensure debt sustainability. The autonomous regions and social security system emerge as the cause of the deviation from budgetary stability targets. However, correcting these imbalances is a general economic policy problem that will require reforms.

The next section of SEFO takes a look at developments in Spain at the industry level, such as: recent changes to Spain´s business landscape and remaining challenges; the key elements of success behind Spanish exports; and the country´s renewable energy promotion regime.

Net business creation was positive last year for the first time since the crisis. However, recent trends in business demography and declines in innovating firms are raising questions over the future. Proposed measures for tackling some of these issues include promoting human capital and innovation, among others.

In the case of exports, Spain´s performance today boasts strong results relative to many European peers. Recent export growth has received a boost from the crisis, as firms tried to compensate for decreased domestic demand. However, Spain´s solid export performance is largely underpinned by decades of rapid expansion, beginning with European integration and the ensuing transformational changes of the Spanish economy's productive structure, as well as within its companies, in response to the demands of globalisation. Despite progress, support measure will be necessary to ensure Spanish production remains focused on increasing companies' export intensities, as the recovery raises the risk of recurrence of trade imbalances.

In an effort to meet EU renewable energy targets, Spain has relied on various support mechanisms over the last few decades. From 1998-2013, Spain essentially used various versions of the feed-in-tariff (FIT) to successfully promote renewable energy installed capacity and generation, in line with EU objectives. By 2013, the overly generous FIT regime had overstimulated investment and resulted in a large electricity sector deficit, threatening the very stability of the electricity system. With a view towards fiscal consolidation, the government undertook a necessary reform of the subsidy regime, replacing FIT with compensation based on obtaining a reasonable return for the project. The new regime was an improvement as regards financial sustainability, but its

interventionist and discretionary character is generating investor uncertainty. Initial data in 2014 seem to already point to a slowdown in investment since the introduction of the new mechanism, which may ultimately hinder compliance with EU Renewable Energy targets going forward.

Finally, we close the May SEFO with an analysis of a potential geopolitical event – Brexit – that, should it come to fruition, would have strong economic and political implications for both the UK, Europe and Spain. While the ultimate outcome remains difficult to predict, a vote in favour of leaving the EU ("Brexit") is likely to have a net negative impact on the UK economy, although the long-term implications will depend on the UK´s ultimate trade relations with the EU and its scope for compensatory action. Brexit could also create significant economic spillovers for the EU, as well as call into question the wider EU project. The Spanish economy is not immune. Unlike most other EU economies, it runs both a goods and services surplus with the UK – 1.3% of GDP. People flows – both tourism and migration – as well as financial interlinkages are particularly strong between both countries.