

consolidated  
directors' report





## ECONOMIC AND FINANCIAL SCENARIO

In 2003 the world economy showed clear signs of recovery, particularly in the US where GDP grew by 3.1% driven by internal demand. This compares with the sluggishness of the Eurozone economy which verged on recession in the first half of the year although managing to end the year with growth of 0.4% thanks to the improvement in the last two quarters.

In this scenario, the Spanish economy overcame the downturn registered in 2002. Growth improved by four decimal points to 2.4% and continued to climb from the second quarter of the year, driven by the strength of the labour market, low interest rates and inflation which ended the year at 2.6% which was 1.4 points down on 2002.

The Galician economy overcame the negative consequences of the Prestige accident. The acceleration in the second half of the year, with growth exceeding the average in the rest of Spain, pushed final GDP growth to 2.3% for the year as a whole. Particularly noteworthy was the positive performance of prices, inflation rising by 2.3% which was two percentage points down on December 2002.

On the financial front, interest rates fell to historical lows in both Europe and the US and central banks practically exhausted scarce monetary reserves in order to underpin demand. In response, the Euribor at 1 year fell to its lowest rate since its creation in June (1.93%), although it rose in the last quarter, setting aside the improved outlook for 2004. Long-term rates ended the year down, following the peak recorded in the summer.

After three consecutive downside years, the main stock markets posted a solid recovery. Expectations of reduced geopolitical instability following the end of the Iraq war, the positive macro data from the US and Southeast Asia, the end of the adjustment in the TIC sector and the favourable outlook for corporate profits in 2004 and 2005 resulted in a sustained rally from the minimum prices posted in March. The Madrid stock market registered the second best performance in Europe and the Ibex 35 rose by 28%, mostly driven by its increased exposure to recovering Latin American economies following the slump in 2002.

The development of the Spanish financial sector in 2003 was consistent with that of the past two years: strong credit growth driven by mortgage loans, a decline in customer funds secured, low non-performing loan rates and an increase in the market share held by the savings bank sector compared with the banking sector. In this scenario characterised by growing competition, the banking sector's renewed interest in the domestic market and very low interest rates, margins continued to be eroded. Following the sluggish performance in 2002, the surplus after tax posted by banks and savings banks rose by 5.9% compared with the previous year.

# THE CAIXA GALICIA GROUP IN 2003

## STRATEGY

Within this framework, Caixa Galicia's strategy focused on managing a scenario characterised by interest rates at minimum levels and leveraging the investment drive and market recovery. From a longer term perspective, measures were also adopted aimed at positioning the entity with respect to demands in a sector where customer relations and business proactively are increasingly significant and in which legislative changes, such as Basle II and IAS, call for the redefinition of strategies, the introduction of new forms of risk management and broad levels of capitalisation. Set out below is an overview of these basic lines of action:

- Focus on **customer loans** as the most profitable item on the balance sheet which mitigates the impact of the fall in interest rates on net interest revenue. Moreover, liquidity and coverage of the portfolio prevailed over growth and contribution to the margin in stock market trading.
- For **customer funds** there was an increase in the Entity's position on the interbank market as a way of transferring the fall in call rates in the first part of the year to the cost of financing while the winning of long-term deposits was promoted to strengthen the Entity's position in anticipation of interest rate rises and ensure adequate compliance with equity requirements.
- The obtainment of commissions continued to be promoted through off-balance sheet products (investment funds, insurance) and services such as payment resources or securities brokering.
- Enhancing productivity and **efficiency**, making progress on the migration of routine operations to automatic call centres and strengthening electronic banking services which, following the launch of On-Caixa, have become a major driver of growth and business.
- Ensuring that **technology and process** are clearly focused on customer service and supporting business actions, promoting the sales capacity of branch offices and favouring the efficient integration of the different distribution channels and cross-selling
- Priority has been given to ensuring **solid** growth through the development of new risk management tools and an increase in capitalisation levels, within the framework of a prudent policy on risk assumption and coverage which has enabled the non-performing loan rate to be reduced to a historical low and the coverage rate increased to a maximum.

The development of this strategic focus pushed business to over €30,000 million for the first time, which is up 16.09% on the previous year, while the consolidated surplus for the year amounted to €166.8 million. These results are discussed in greater detail below.

Unless otherwise stated, the percentages set out below relate to the year on year variation at December 2003 and the amounts refer to the balance at that same date.

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### a) Investment

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**Customer loans** rose by 18.60%, which is four points up on last year, to a balance of €12,107 million. Growth was particularly marked in the mortgage business where the volume formalised totalled €2,126 million. Rigorous and prudent risk management enabled the doubtful loan balance to be reduced to 0.37% of the portfolio while the coverage rate stands at 568.41%.

Investment in the **securities portfolio** grew by 6.93% to €10,126 million, growth in variable income securities taking precedence (up 52.28%) within a scenario of stock market recovery. The quality of the portfolio is borne out by the volume of latent capital gains which exceed €223 million.

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## b) Customer funds

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Off-balance sheet products played a lead role during the year (investment funds, pension plans and insurance) together with the issue of fixed income securities, which enabled customer funds to be increased by 14.49% to €18,284 million.

The increasing appeal of investment funds and the effort made to market insurance resulted in a 23.98% rise in off-balance sheet. Low interest rates were leveraged to carry out four issues of fixed income securities- Eurobonds, junior bonds and preference shares - for an overall amount of €590 million.

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## c) Services

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**Remote distribution** channels grew markedly as the number of electronic banking customers reached 270,606, up 27.28% on 2002. Together with other resources (ATMs, PoS Terminals, automatic processes and mobile offices), the Entity performed 35.6% of the 392.46 million customer operations effected in 2003 through channels other than branch offices.

On the services commission front, off-balance sheet products marketed generated €23 million, which is up 8.46% on 2002, driven by the solid performance of this product range. Also noteworthy was the 11.23% rise in the payment means line and the 18.79% increase in the number of securities related transactions.

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## d) Results

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The highlights are as follows:

- Net interest revenue remained practically consistent at €425.7 million.
- Revenue from the provision of services grew by 14.18%, which enabled the basic margin to be increased (the most stable part of the Entity's revenue) to €492.4 million, representing an increase of 1.13%.
- The solid performance of the financial markets increased net ordinary revenue by 2.95% to €508.4 million.
- The strengthening of the Group's subsidiaries entailed a 5.04% increase in operating expenses. Nonetheless, with respect to the parent, the 16% rise in productivity per employee favoured the containment of operating expenses, which grew by 0.9% in real terms (3.5% in nominal terms). This enabled the Group to maintain its capacity to generate results by obtaining net operating revenue of €210.4 million which is up 0.14% on 2002.
- The contribution of Corporación Caixa Galicia to the group's consolidated surplus amounted to €14.4 million. Particularly noteworthy is the increase in the contribution of the investees carried under the equity method, led by Unión Fenosa and Ence, that posted record profits in 2003.

Finally, the surplus before tax amounted to €214.9 million, 6.31% up on the previous year. Following mandatory compliance with tax obligations, the consolidated surplus for the year amounted to €166.8 million. This allowed the amount transferred to the community project reserve for 2004 to increase to €51.5 million.

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## Other information

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The Caixa Galicia network comprised 715 units at the year end, 35.7% of which are outside Galicia (six in Portugal) and eight are representative offices located around Europe and Latin America. The number of ATMs amounted to 863 and PoS terminals stood at 20,299.

The number of employees involved in the Group's ordinary activities stood at 4027 at 31 December 2003.

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## Corporación Caixa Galicia

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The Corporación Caixa Galicia Group posted a consolidated surplus after tax of €86.17 million, 32% up on the previous year. In 2003 capital was increased to €150 million in order to have the necessary resources to continue the institution's investment activities.

Activities are structured in two areas. The **Operations Area** encompasses the subsidiaries (group of companies) that take on new lines of business complementary to the financial activity and venture capital operations performed.

The Group of companies grew the volume of business to €210.41 million with significant improvements in all areas. The surplus before tax amounted to €10.14 million, representing an increase of 8.67%. Noteworthy is the acquisition by Corporación of 50% of Ciberviaxes, which was owned by Viajes Iberia, for €0.5 million, enabling it to acquire full ownership of this subsidiary.

Venture capital investment is led by the management company Gescaixa Galicia. In its fourth year of operation it invested €5 million in four new projects and seven capital increases with respect to current operations. New acquisitions were Assistens (healthcare), Zeltinova (biotechnology), Resgal Viveiro (residential facility for the elderly) and Gainmédica (bio-medicine).

**Shareholdings in companies** include direct investment in companies, managed with a view to combining both favourable profitability prospects and a beneficial effect on the financial landscape through a presence in strategic companies and sectors. Throughout the year €320 million was invested, pushing the Corporación's portfolio to €738.13 million, up 21.9% on 2002. This portfolio includes latent capital gains of €173.5 million.

At the start of the year two major operations were formalised which had been arranged in the last quarter of 2002: the acquisition of a 37.12% stake in the capital of Banco Etcheverría and the completion of the takeover bid over ENCE, which pushed the holding owned of 12% to 17.7%.

During the year, also noteworthy was the successful bid submitted by the consortium in which Corporación also participated (through a 10% stake) in the tender for the privatisation of ENA (Empresa Nacional de Autopistas), for €162.2 million. ENA has in Spain 463 km of toll motorways, 57% of which are in Galicia.

In August 2003 a 1.5% stake was acquired in the capital of Sacyr-Vallehermoso, one of the leading construction companies in Spain, for €33.7 million.

Finally, noteworthy was the acquisition of a stake in Plásticos Ferro (20% of capital, €16 million), one of the five leading European piping and thermo-plastic accessory manufacturers and the increase in the investment in Iberia to 3.5%, through an investment of €7.6 million.

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## Community Projects

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Expenditure in Community Projects in 2003 amounted to €49.45 million, which enabled a wide range of social- cultural activities to be carried out, involving 215 municipalities and almost two million people. The most noteworthy projects in the year included the implementation of a special plan for those groups most affected by the *Prestige* tragedy. This plan, to which €9 million was appropriated, covers not only support in relation to the initial cleaning work but also investment in social infrastructures and equipment, programs aimed at promoting tourism and measures to regenerate the environment.

Other particularly noteworthy initiatives included:

- As regards care for the elderly, progress continued on the geriatric residential facilities plan with the start-up of the Naron centre and the commencement of work in Veveiro and Vigo. This programme was complemented by solidarity, training, leisure and free time initiatives which are performed through the network of centres for the elderly. More than 33,000 users benefited from these initiatives.

- Investment in the cultural programme amounted to €15 million. The most noteworthy activities included the organisation of 159 exhibitions, 361 concerts and 251 plays.
- The consolidation of socialia.org, the Internet portal supporting volunteer work, which at the 2003 year end included 435 non-profit organisations and 816 individual members.
- The opening in Lugo of a new Ciberalia computer classroom that promotes contact with information technologies among the sectors of society that may have access difficulties. In 2003 there were more than 8,810 members and over 76,377 users.

Nonetheless, the Entity's commitment towards society goes beyond its social work and transcends all fields of its economic and financial activity. This accounts for the start-up of a Corporate Social Responsibility Plan. The Entity was the first Spanish savings bank to join the World Global Pact promoted by the United Nations in order to favour sustainable growth. This CSR plan will involve the entire organisation and lay down the guidelines for a responsible relationship with customers, employees, suppliers and the environment.

## RESEARCH & DEVELOPMENT ACTIVITIES

- **Technological development.** The 2003 investment programme was structured through a qualitative goal management system, ensuring its consistency with the strategic business focus. The most noteworthy projects were the renewal of the branch office network, the strengthening of physical and logical security and the enhancement of the technological architecture process. Moreover, work started on the transformation of the management information system and a corporate data warehouse was created on the Teradata platform.

Caixa Galicia was considered to have reached stage 2 of evolution in process maturity under the CMM (Capability & Maturity Model), which is the most important international standard to measure the quality of software generation processes and their level of alignment with the entity's business. This certificate has only been granted to ten companies in Spain. The adoption of the CMM enables best practices in technological development generated by the technology industry worldwide to filter down throughout the entity.

- **Centro on.** In December 2003 Caixa Galicia opened the first On CaixaGalicia office. This is a pioneering initiative which combines business supported by new information technologies and communication with virtual art in a single physical space. The initiative aims to offer a preview of what a branch office will look like in the future, with no counters, in which on-line self-service will be combined with personalised service and advice.
- **Financial innovation .** In a scenario characterised by tight competition and in order to address specific demands from the public, there is a need for the on-going launch of new products and services. Last year this resulted in the market launch of 67 new product and service offerings. The most relevant are as follows:

In the mortgage sector, the entity launched seven new mortgages with differing recipient segment, duration, fixed or variable interest rate and business channel combinations in addition to "Caixa Protección", an instrument covering variable rate mortgages.

On the liabilities side, four mixed deposits and seven term "on depósitos" were launched on the Spanish market and a further three on the Portuguese market. With respect to the off- balance sheet range, six new mixed – variable income investment funds were launched together with four new life insurance products under the *Bia Asegurada*.

For companies the company saving account was started up together with a supplier payment management or confirming service.

## SIGNIFICANT EVENTS IN 2004

- a) Within the Strategic Plan framework designed to duplicate the volume of business and increase branch offices to 1,000 in 2010, the Entity started up a **new organisation structure** that has been set out in the organisation chart. This structure strengthens three basic areas of activity: a business area through a plan to drive the network's sales capacity, market operation and Community Projects and Caixa Galicia foundation.
- b) In February a new series of **junior bonds** was issued amounting to €70 million, which was fully subscribed before the end of the subscription period.
- c) **Corporación Caixa Galicia** increased its investment portfolio with two new operations.
  - 1) A purchase option was exercised over a further 7.6% of Banco Echeverría for €2.7 million, enabling its holding to be increased to 44.7%.
  - 2) €58,4 million was appropriated to strengthen its position in Sacyr-Vallehermoso, that stands at 2.26%.
- d) In January Caixa Galicia signed the contract for the **sponsorship of Xacobeo 2004** with the regional government under which an intense cultural programme will be undertaken, comprising exhibitions, publications, concerts, theatre and cinema.
- e) Towards the end of January Caixa Galicia received the "financial institution of 2003" "**Euro de oro**" award from the Association of Users of Banking Services (Ausbanc).

## OUTLOOK FOR 2004

Relaxed monetary and fiscal conditions in the US and Europe should drive family consumption and business investment, while the export sector will be favoured by the recovery in international trade. However, the economic cycle will continue to be more dynamic in the United States although there are still some question marks hanging over the situation.

In this scenario, the Spanish economy will continue to register a significant growth differential with respect to the Eurozone. There will, however, be some changes as investment in capital goods will take over from family consumption as the driver of such growth. GDP will increase by approximately 3% next year. Galicia will grow in excess of the average in Spain, driven by sustained private consumption, the improved performance of investment in public works within the framework of the Galicia Plan and the impact of the celebration of the Xacobeo 2004 holy year. With respect to the impact of the development of the economy on the financial landscape, European interest rates will be left on hold at reduced levels for most of the year although rates are expected to rise in the last part of the year if the European economy recovers. Long-term interest rates will register more moderate growth which will lead to the levelling of the interest rate curve at the year end.

In this scenario, the entity will focus its strategy on the following:

- Promote the **retail banking business**. While leveraging the strength of mortgage loans, personal loans will be promoted, taking advantage of the acceleration in the Spanish economic cycle, sustained family consumption and the recovery of business investment. The customer funds business will continue to focus on long-term products, leveraging the favourable interest rate situation.
- This strategic line of action will be supported by the opening of 47 new offices and the strengthening of **On-Caixa**, the virtual banking service, as a sales channel supplementing the traditional network. At the same time, the network's business network will be enhanced together with customer relations through the CRM tools.
- **Diversification** of the business by strengthening lines generating commissions. A specific plan has been designed to market insurance following the excellent results obtained in 2003, which was the first complete year of business after

the restructuring undertaken following the agreement with the AVIVA Group and the formation of the Insurance Brokers. Another priority line for 2004 relates to the operation of payment resources.

- Growth must continue to be healthy and solvent. There will therefore be a focus on efficiency and a drive to migrate operations to remote channels and increase employee productivity. The Entity's solvency will be strengthened through new issues and risk management supported by the start-up of the tools envisaged as "advanced models" in the new Basel II agreement on capital.

As a result of these lines of business, Caixa Galicia will end the year with a volume of business of €35,600 million and a surplus of more than €220 million.