

BUSINESS ENVIRONMENT

05



economic / financial environment

14

ECONOMIC / FINANCIAL ENVIRONMENT

THE ECONOMIC ENVIRONMENT

2004 was a particularly good year for the global economy, with production increasing at its highest rate (5%) since 1976. The motor for this upswing was threefold: the high rate of growth in the US (4.4% over the year, the highest since 1999), the continuing expansion of the Chinese economy, which is now the world's third largest exporter, and the recovery of the Japanese economy.

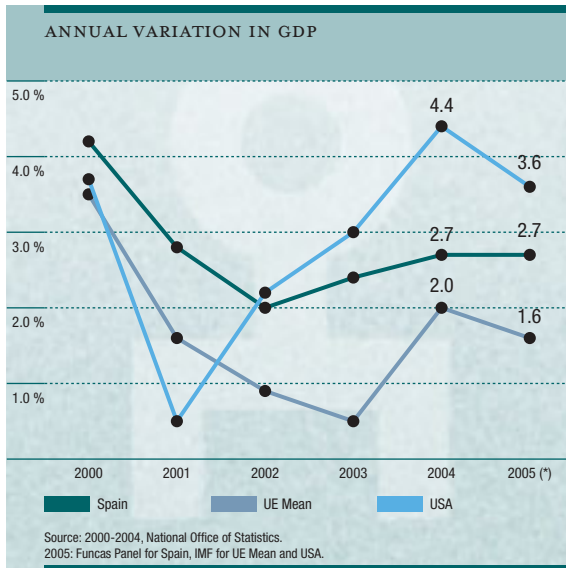
This surge reached the emerging market nations, particularly in Latin America and Southeast Asia, but had little effect on the economy of the Eurozone, which only registered a 2.0% increase. The appreciation of the euro and the surge in oil prices combined to undermine the positive

effects of the external sector, preventing the upswing in the global economy from reaching consumer and company spending, particularly in Germany, the largest economy in the area.

In **Spain** production increased by 2.7% over the year, 0.2% more than in the previous year. Domestic demand continued its steady upward growth, spurred by low interest rates and rising job creation: 461,300 new jobs were created, 2.5% up on 2003. The most encouraging news in this area is the recovery of investment in capital goods after two extremely poor years.

The strength of domestic demand in comparison with that of other countries in the Eurozone, the appreciation of the euro and the constant loss of competitiveness led to a serious widening of the trade deficit, with the external sector accounting for a 1.7 point reduction in GDP, 0.9 points more than in 2003.





In this context, the **Galician economy** attained a positive growth differential with regard to the rest of Spain. GDP increased by 3%, 0.3% more than the average for Spain, on the back of three major factors: tourist growth as a result of the Jacobean Holy Year 2004, the consistent strength of the construction industry, both in housing and in infrastructures, and a lower negative contribution by the external sector thanks to an increase in exports.

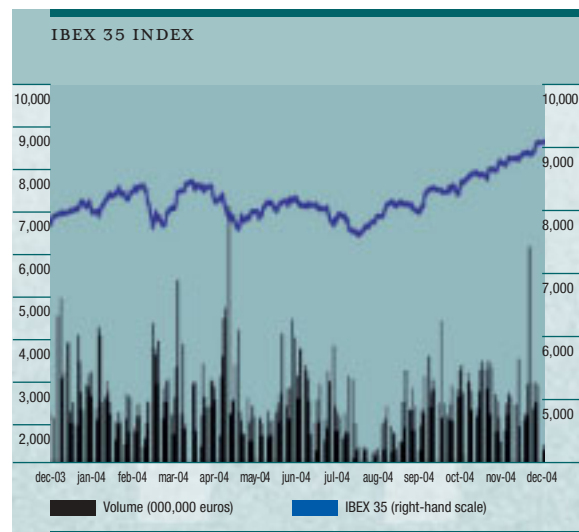
The strength of the economy was reflected in the surge in the labour market, with Galicia among the leading regions in this field, with 37,400 new jobs created (3.4% up on 2003, placing it sixth in the ranking of Spanish regions), and a 4.9% fall in unemployment.

THE FINANCIAL ENVIRONMENT

Interest rates throughout Europe remained at historically low levels during 2004, with the markets detecting no signs of expansion in the economic cycle that could lead to the European Central Bank deciding to raise interest rates in the near future. The opposite was true in the US, where the Federal Reserve applied the brakes to its highly expansive monetary policy of the last few years through a progressive increase in interest rates.

The European Central Bank therefore maintained its reference rate at 2% throughout the whole year. The threat of the effect of a steep rise in oil prices on European growth meant that during the first half of the year the markets even discounted a relaxation in the reference rate, so that the 1 year Euribor in fact dropped below 2% in March, to recover slightly later and staying at around 2.3% for the rest of the year.

With regard to long-term rates, yields of European public debt plunged to a historical low at the end of the year. The refusal of the ECB to increase interest rates, the lack of





price tensions, and the diversification of assets by central banks of emerging nations with substantial dollar holdings all led to a strong demand for European fixed income securities, thus increasing their price and reducing return.

With regard to other markets, the European stock exchanges showed gains for yet another year, although this time not to the same extent as in 2003. The Ibex35, with a gain of 17%, led the ranking of major European indices, and was above the German DAX (+7.3%), the French CAC (+7.6%) and the British FT100 (+7.7%). In the US, the conviction that the latest expansive mini-cycle had peaked was reflected in even more modest gains in the Dow Jones (+3.3%) and the S&P500 (+9.1%).

Finally, the currency market was one of the main areas of interest for financial sector, with the euro reaching an all-time high against the dollar (1.36 USD/EUR) in December. The greenback was affected by the failure to control the twin deficits (fiscal and external), which cancelled out the possible beneficial effects of interest rate increases by the Federal Reserve.

| FINANCIAL ENVIRONMENT | | | | |
|-------------------------|-------|-------|-------|-------|
| | Q1-04 | Q2-04 | Q3-04 | Q4-04 |
| Repo | 2.00% | 2.00% | 2.00% | 2.00% |
| Fed Funds | 1.00% | 1.25% | 1.75% | 2.25% |
| Euribor 1 Year | 1.98 | 2.43 | 2.39 | 2.36 |
| Spanish Public Debt 10Y | 4.03 | 4.34 | 4.02 | 3.70 |
| Euro/dollar | 1.22 | 1.22 | 1.24 | 1.36 |

Figures correspond to the last day of each quarter.

Financial Sector

Business in the financial sector evolved in much the same way as in recent years: strong credit growth

and a more moderate rate of growth in customer deposits, which was made up for by an increase in the volume of issues. The rate at which money flowed towards investment funds also slowed down over the year.

On the liability side the capture of balance sheet resources increased by 12% compared to 2003. Whilst traditional deposits grew at a rate of 11% for on sight deposits and 16% for term deposits, the capture of funds through bonds and debentures increased by 60%, and represented 14% of borrowed funds.

Spanish banks and savings banks found the solution for financing the dynamism shown by credit in the securitisation of their loan portfolio, particularly mortgages. The Spanish securitisation bond market was therefore the second biggest in Europe during 2004. 75% of issues were of mortgage bonds or debentures, amounting to a total of 38,000 million euros. Savings banks were particularly active in this segment and at the close of the year only three institutions had yet to issue this kind of bond.

On the asset side, customer lending continued to grow strongly, closing the year with an increase of 16%. Housing-related finance continued to defy all forecasts of a slowdown and increased by 18%, practically the same rate as in 2003. At the same time, consumer and investment activity reflected the dynamism of the Spanish economy with rates of increase that, although lower than the above, were still up on the previous year.

Non-performing loans, for their part, remained at historically low levels (under 1% of total credit balance) and coverage levels increased.





This strong credit growth was accompanied by a slowdown in the securities portfolio, which only managed to grow by 1.4%, in comparison with the 12.4% rise it registered in 2003. The expansion of the variable income portfolio in response to the favourable expectations of gains on the Ibex35 ran parallel to the fall of long-term interest rates to an all-time low, with financial institutions taking the opportunity to realise their capital gains and reducing their position in this market.

In the case of off-balance sheet activities, investment funds slowed down after the very strong growth reg-

istered in 2003, due to the lack of opportunities for gains in money markets and long-term fixed income markets alike.

In terms of results, the fact that interest rates remained extremely low prevented any significant increase in trading margins. Nevertheless, the positive performance of commissions and the results from financial operations allowed profits to increase by 5.76% for the savings bank sector as whole.



LEGISLATIVE ENVIRONMENT

This section includes the legislation which was published or came into force in 2004 and which has an effect on the activities of the Caixa Galicia Group.

National Legislation

- Law 33/2003 of 3 November, on Assets of the Public Administrations (Official Gazette 264 of 4 November), which came into force on 4 February 2004.
- Law 38/2003 of 17 November, on Subsidies in General (Official Gazette 276 of 18 November), which came into force on 18 February 2004.
- Legislative Order in Council 1/2004 of 5 March, approving the Combined Text of the Law of Land and Property Registry (Official Gazette 58 of 8 March)
- Legislative Order in Council 2/2004 of 5 March, approving the Combined Text of the Law Regulating Local Treasuries (Official Gazette 59 of 9 March)
- Law 3/2004 of 29 December, on measures to combat payment default in commercial operations.
- Order in Council 1721/2004 of 23 July, on measures to finance protected actions in land and housing included in the 2002-2005 Plan.
- Order EHA/3050/2004 of 15 September, on the reporting of entailed activities by companies issuing securities admitted for trading in official secondary markets.
- Order ECO/697/2004 of 11 March, on Central Risk Reporting.
- Royal Decree 171/2004 of 30 January, implementing section 24 of Law 31/1995, on prevention of hazards in the workplace, in the question of the co-ordination of business activities.
- Bank of Spain Circular 1/2004 of 29 July (amending Circular 3/1995) on Central Risk Reporting.
- Bank of Spain Circular 2/2004 of 23 July, to institutions participating in TARGET-SLBE, on the updating of the settlement system in case of malfunction of the TARGET system.
- Bank of Spain Circular 3/2004 of 23 July, to credit institutions, extending the list of Multilateral Development Banks contained in Circular 5/1993 of 26 March, on the definition and control of minimum capital and reserves of credit institutions.
- Bank of Spain Circular 4/2004 of 22 December, to credit institutions, on standards for public and reserved financial information and models of financial statements.
- Bank of Spain Circular 5/2004 of 22 December, to credit institutions, on the repeal of Bank of Spain Circulars 22/1992, 1/1993, 2/1997 and 12/1998.
- The coming into force on 1 September 2004 of the Insolvency Act.
- The coming into force on 21 January 2005 of Regulation 805/2004 of the European Parliament (passed in 2004) establishing the “European executive deed for undisputed credits” which will allow the execution in any EU member State of and executive deed (court order or public document) obtained or formalised in any other member State. It will apply





generally in the whole of the EU as from 21 October 2005.

Regional legislation (Galicia)

- Law 6/2004 of 12 July, regulating the bodies to defend competition in the Autonomous Region of Galicia.
- Law 11/2004 of 19 November, on consumer inspections in Galicia.
- Decree 257/2004 of 29 October, on the legal system governing state-subsidised housing, state-subsidised commercial premises and land.
- Decree 35/2004 of 6 February, regulating subsidies to tenants within the framework of the rented Housing Exchange Programme of the IVGS (Galician Institute of Housing and Land)
- Law 1/2004 of 21 April, amending Law 7/1985 on Galician savings banks and Law 4/1996 on Galician savings banks, to bring them into line with the national law on measures to reform the financial system.
- Decree 276/2004 of 18 November (amending Decree 153/1989) on the governing bodies of Galician savings banks.
- La 15/2004 of 29 December, amending Law 9/2002 of 30 December, on land use and protection of the rural environment in Galicia.



IMPLEMENTATION OF THE INTERNATIONAL ACCOUNTING STANDARDS (IAS) IN CAIXA GALICIA

During the course of 2004 the Bank of Spain passed and issued its "Circular 4/2004 of 22 December, to credit institutions, on standards for public and reserved financial information and models of financial statements", which came into force on 1 January 2005, although it is not applicable to individual statements until 30 June of the same year. This Circular modifies the accounting system of Spanish credit institutions, adapting it to the new accounting environment deriving from the adoption by the European Union of the International Financial Information Standards (IFIS) through Community Regulations, according to the provisions of Regulation 1606/2002 of the European Parliament and Council of 19 July 2002, regarding the application of the International Accounting Standards.

In 2003 Caixa Galicia Group started preparatory work and analysis to enable it to adapt to the demands deriving from the contents of EC Regulation 1606/2002. This process continued throughout 2004 and will end on 30 June 2005, when the provisions of the above-mentioned Bank of Spain Circular 4/2004 will be met in full.

An important aspect of Circular 4/2004 is that it combines, on the one hand, continuity with the special role played by accounting aspects in the Spanish regulatory model for banking activities, and on the other, the need to adapt to the new accounting framework represented by the IFIS. Amongst those aspects concerning continuity, one of the most important is that of provisions, in which both the sought-for accounting aims (a correct valuation of inherent losses in credit portfolios) and the supervisory and macro-prudential aims (enhancing the individual strength of each institution

and the stability of the Spanish financial system as a whole) are in line with the aims that until now had been included in Circular 4/1991. With regard to the process of adapting to the IFIS, mention must be made of a more widespread application of reasonable value as a criterion for evaluating certain balance sheet aspects of credit institutions.

The effect of the new accounting standards on the financial sector

In the case of Spanish institutions, the most significant change deriving from the new accounting policies introduced by Circular 4/2004 and the IFIS is the **precedence taken by the principle of faithful image over the principal of prudent valuing**. The latter had been the dominant principle in accounting standards applicable in our country until now (and contained, in the case of credit institutions, in the Bank of Spain Circular 4/91).

Amongst the expected **effects** of the application of the new accounting standards to the financial statements of credit institutions the following are the most important:

- > **Alterations** which may be of significance in the **profit and loss account** and in the **reserves account**, due in the main to the fact that certain assets and liabilities of these institutions will be recorded in the financial statements at 'fair value', which means a value close to the market price of these assets and liabilities.
- > Changes to the criteria for **calculating provisions** for the depreciation of asset value, provisions for insolvency and other provisions in general.



- > New criteria regarding the **treatment in the accounts of goodwill** arising when businesses are combined (mergers and acquisitions).
- > Changes to the **structure of the balance sheet and the profit and loss account**. One of the most important aspects is the obligation to include the derivatives portfolio in the balance sheet (until now they had been included in the memorandum accounts).
- > A different definition of the **composition of the companies included within the consolidated accounts perimeter**.
- > **New accounting statements** have been approved, such as the “statement of changes in net worth” or the “cash flow statement”. A further modification is the considerable increase in the information that must be included in the notes to the financial statements.

In short, a **new regulatory framework** has been created, which is currently the object of detailed in-depth analysis, and which will have a substantial outcome on the decisions of a strategic nature to be taken in relation to the business of financial institutions.

Furthermore, financial institutions are having to expend considerable resources in their computing, organisational and staff training and information areas in order to adapt to the IFIS.

Actions taken by Caixa Galicia

In 2003 the company set up a **Committee** of senior management personnel from the main areas affected

by the process of introducing and putting into practice the IFIS. This Committee carried out a systematic process to analyse each and every one of the IFIS in accordance with the following **basic aims**

- > To enable **Caixa Galicia Group to adapt itself to the IFIS within the period of time laid down by EU regulations**, including the development and adapting of all the computer processes, the review and adaptation of the operational processes and the design of those processes that would enable accounting information to be produced that would comply in full with all the requirements of the IFIS.
- > To have **an exhaustive knowledge of the consequences of adapting to the various IFIS**, by means of a preliminary evaluation and valuation of their possible impact and by establishing a channel of communication with all the business and organisational areas and top management, allowing all concerned to have accurate knowledge so as to be able to make strategic decisions as soon as possible.
- > To ensure that **all the employees of the Group received full internal information regarding the IFIS**, with particular attention being paid to those areas directly involved in the production, treatment or analysis of accounting and financial information.

The final goal was to lay the foundations for a successful implementation of the new standards and strict compliance with all the deadlines and requirements established under the new legislation, and to complete the process with the issuing of financial statements that would be in full consonance with the new regulations.





This process continued throughout 2004 and will come to an end, as has been mentioned above, with the **full adaptation**, on 30 June 2005, to the provisions of

Bank of Spain Circular 4/2004 and all applicable international legislation.

