

During 2012 and the first few months of 2013 very significant progress was made in the process of balance-sheet clean-up, recapitalisation and restructuring of the Spanish banking system, based essentially on four courses of action: identification of the individual capital needs of each bank; recapitalisation and restructuring (or in the event of non-viability, orderly resolution) of those institutions in situations of greatest vulnerability; write-downs, separation and transfer of assets related to the real-estate sector and, finally, a significant regulatory reform.

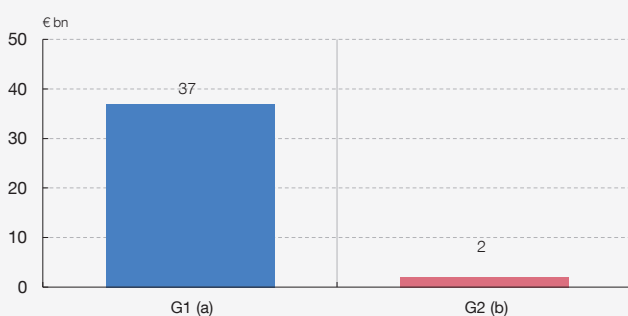
Given that this plan of action required the mobilisation of public funds and that the financial tensions and heavy financing requirements of the public sector limited the capacity to obtain funds at reasonable prices on the markets, the Spanish government requested financial assistance from its fellow EU members to carry it out. Specifically, the aid took the form of a financial assistance programme to recapitalise those banks that needed to be recapitalised, with funds available of up to €100 billion. The related conditionality for the financial system was contained in the Memorandum of Understanding (MoU) signed on 20 July 2012. This document established the specific measures that would have to be adopted in two spheres: that relating to those institutions that

have required public aid and that relating to the sector as a whole. The final objective of all these measures is to increase the resilience of the financial system to adverse shocks.

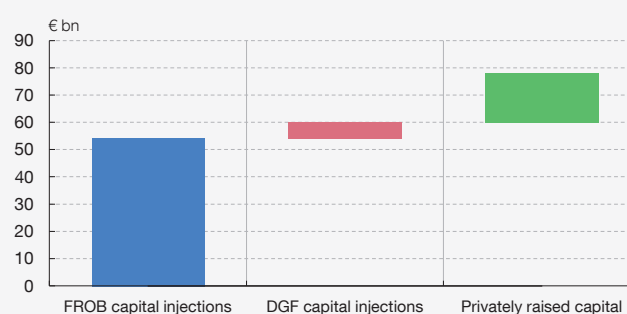
In order to determine capital needs, the authorities commissioned independent experts to perform two stress tests. The first one, carried out in June 2012 by two consultancy firms, was an aggregate top-down test in which Spanish banking groups that together accounted for around 90% of the assets of the sector participated. Two macroeconomic scenarios were considered: a so-called baseline scenario, assumed to have a high probability of occurrence, under which a core capital ratio (as defined by the European Banking Authority) of 9% was required to be met as at the end of 2014, and another adverse scenario, considered very unlikely to occur (its probability of occurrence was estimated to be less than 1%), under which the level of ratio had to be at least 6% as at the same date. According to the results, published on 21 June, the system was estimated to need additional capital of €16-26 billion under the first scenario, and €51-62 billion under the second one.

After this initial work, which served to put an upper limit on the system's overall capital shortfall, the second stress test was

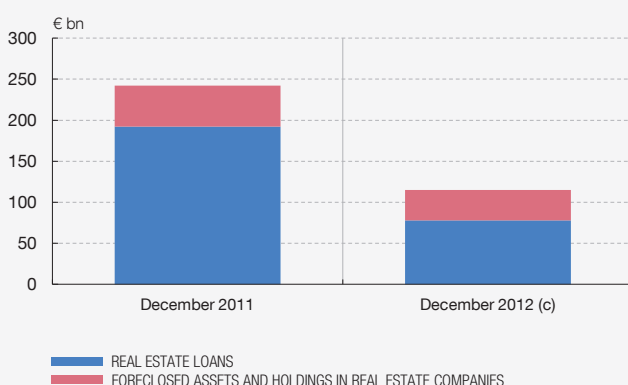
1 PUBLIC CAPITAL AID AFTER THE STRESS TEST



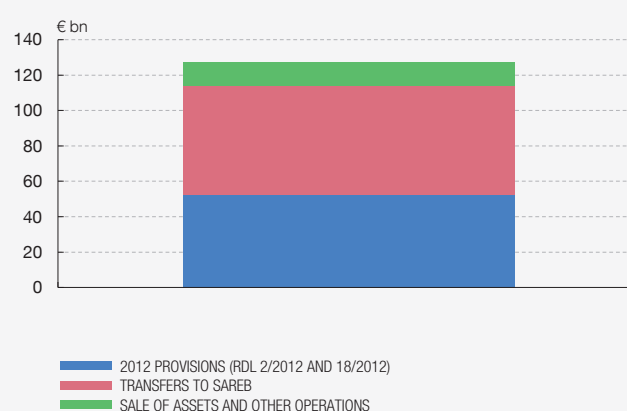
2 CAPITAL INJECTIONS DURING THE CRISIS



3 EXPOSURES NET OF PROVISIONS TO THE REAL ESTATE SECTOR



4 REDUCTION IN EXPOSURES TO REAL ESTATE SECTOR IN 2012



SOURCE: Banco de España.

- a Banks with a FROB majority shareholding.
- b Other banks with additional capital needs.
- c Assets transferred to SAREB in February 2013 by Group 2 banks are not included.

carried out between July and the end of September, to determine the capital needs of each institution (bottom-up exercise). The scenarios, capital requirements and institutions considered were the same as in the first test and one of the consultancy firms that performed the first test was commissioned to conduct it, along with the four main Spanish audit firms and six domestic and international real estate valuation companies. The test was conducted very rigorously, using very exhaustive information, with strict control of the process, the governance of which involved both the Spanish authorities (Banco de España, Ministry of Economic affairs and competitiveness and the FROB) and international authorities (European Commission, European Central bank, European banking authority and the International Monetary Fund, in an advisory role). According to the results, which were published on 28 September, the maximum total capital needs were estimated to be €57 billion under the adverse scenario, which were distributed across the institutions very unevenly. More specifically, of the 17 groups analysed, seven (which accounted for 62% of the loan portfolio), had no need for additional own funds, while in the case of the other ten, the needs identified were concentrated (86% of the total) in four institutions in which the FROB already had majority holdings at the time.

The second component of the strategy has been the recapitalisation of viable entities identified as having a capital gap. Of the ten institutions in that situation, two were capable of covering the gap on their own by means of capital increases, subordinated debt repurchases and asset liquidation. The others needed public aid provided by the FROB and financed through the MEDE, within the framework of the approved financial assistance programme. The volume finally injected was, however, lower than that estimated in the stress tests, as a result of the application of a number of measures, in line with the agreements contained in the MoU, including the assumption of losses by the holders of shares and hybrid instruments, the transfer of assets to the institution set up for their management and sale (asset management company for assets arising from bank restructuring (SAREB)) and the divestment of other assets. Following these adjustments, public aid was €39 billion (see Panel 1), of which €37 billion was given to the institutions in which the FROB had a majority holding (Group 1), and the rest, to those other banks that could not cover their capital needs on their own and that make up the so-called "Group 2". The injections were completed in December 2012, in the first case, and March 2013 in the second (except in the case of one institution, for which the injection was made in April). The institutions that received public aid have presented, in accordance with the provisions of the MoU, restructuring plans that contain commitments to make very significant reductions in the number of offices, employees and risk-weighted assets during the period 2010-2017 (of 60%, 50% and 60%, respectively, in the case of the Group 1 institutions, and 40%, 40% and 50% in that of the Group 2 institutions). These plans have already been approved by the Banco de España and the European Commission.

Following these new contributions from the FROB, the total amount of public aid provided in the form of capital since the start of the crisis amounts to €54 billion. In addition, the Deposit Guarantee Fund (DGF) had already carried out recapitalisations of €6 billion, to which must be added the private capital increases, which have involved a further €18 billion. In total, the recapitalisation of the financial system during this period exceeds €78 billion (see Panel 2).

The objective of the third pillar of the strategy was to clean up bank balance sheets and reduce their exposure to the real-estate sector. Royal Decree-Laws 2/2012 and 18/2012 introduced measures to ensure a rapid and transparent recognition of possible capital losses associated with real-estate assets, increasing the levels of the specific and general provisions and establishing the need for an additional capital buffer to cover possible losses associated with assets relating to land. With the application of the new rules, the coverage of assets relating to real-estate development would reach 45% of their total amount, and 80% in the case of land.<sup>1</sup> Subsequently, and in accordance with the MoU, in December 2012 the SAREB was set up, a company whose purpose is to manage real-estate assets, which currently has a capital of €4.8 billion, 44% of which is held by the FROB (the rest being mostly held by private investors, banks and insurance companies). The institutions that have received new public aid have been required to transfer to this company all their foreclosed real-estate assets and loans to developers with a net book value of more than €100,000 and €250,000, respectively, as well as controlling shareholdings linked to the real-estate development sector. The transfer price was calculated, following the conditions of the MoU, according to the economic value of the assets, to which some additional adjustments were applied, with an average cut of 65% in relation to the book value for the foreclosed assets and 48% of loans. In December 2012 and February 2013 the assets of the Group 1 and 2 institutions were transferred, respectively, with a total effective amount of €51 billion.<sup>2</sup> For the SAREB a business plan has been designed with a 15-year horizon and its management is supervised by the Banco de España, along with other domestic and international authorities.

As a result of all these measures and, to a lesser extent, the sale of assets and other actions, the total net exposure (after applying provisions) of the bank balance sheets to the real-estate sector has been reduced, during 2012, by €127.2 billion, as may be seen in Panels 3 and 4.<sup>3</sup>

Finally, the fourth component of the strategy was focused on regulatory reform. Specifically, RDL 24/2012, approved on 31 August

- 1 This limit was reached through the requirement for an additional capital buffer. However, as this requirement was lifted by RDL 24/2012, the coverage of land is now 60%.
- 2 The assets were recorded on the balance sheets of institutions with a gross amount of €106 billion.
- 3 In order to calculate this amount the transfer to the SAREB of the Group 2 assets, which took place in February 2013 has been taken into account.

## PROGRESS MADE IN THE BALANCE-SHEET CLEAN-UP, RECAPITALISATION AND RESTRUCTURING OF THE SPANISH BANKING SYSTEM (cont'd)

BOX 1.3

2012, established a modern framework for the management and resolution of banking crises (with more rapid intervention by the Banco de España in the event that difficulties are detected at an institution), delimited the competencies of the FROB and of the DGF and strengthened the tools of the former in all phases of crisis management. In addition, the Banco de España assumed the power to authorise and sanction credit institutions (a function previously performed by the Ministry for Economic Affairs and Competitiveness), and a more demanding capital requirement was established that credit institutions had to meet from 1 January of this year, a minimum level being set for core capital<sup>4</sup> of 9%. This royal decree also addresses other aspects, such as placing limits on the remuneration of the directors of institutions that have received fi-

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4 As defined by the European Banking Authority.

nancial support and improving the mechanisms for protecting retail investors, by requiring greater transparency in the marketing of products not covered by the DGF. More recently, Circular 6/2012 was approved, which introduced greater transparency into the financial reporting of institutions, especially in relation to real-estate exposures and refinanced and restructured loans. In the coming months new legislation is expected to be approved to convert savings banks, whose activity is now carried out through commercial banks in practically every case, into foundations, which will have significant incentives to reduce their holdings in such commercial banks below controlling levels, thereby completing the process of reform of the model of governance of this type of institution that was commenced in 2010. Finally, work is currently done to improve the supervisory methods of the Banco de España and the system of provisions for loan impairment.