BANCO DE ESPAÑA
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Savings Banks: Developments and Reform

1 Introduction

The Spanish banking system withstood reasonably well the initial phase of the crisis that broke in the summer of 2007, since it neither marketed nor invested in complex or "toxic" credit products. The banking regulation and supervision framework in place in Spain also helped contain the effects of the international financial crisis.

However, during the preceding long phase of economic expansion, the Spanish banking system had built up certain imbalances. Both its capacity and credit, especially that extended to real estate development and construction, had grown at rates that were unsustainable over the medium and long term. Moreover, this expansion was largely funded by the international fixed-interest markets, since the deposits raised from Spanish households and firms did not suffice to sustain such strong growth in lending.

Even so, not all banks have been affected to the same degree by the current, prolonged crisis, which has moreover passed through to the real economy. Indeed, the effects have been concentrated above all at certain savings banks, namely those which had built up imbalances most sharply.

In recent months savings banks have undergone an intense concentration process. Their number has fallen from 45 to 17 institutions or groups, the aim being to improve their efficiency through capacity reduction. In parallel, credit institutions have made a full-scale transparency drive, disclosing all the data on their actual situation and their risks (in particular their real estate exposure and dependency on wholesale funding), and they have set about sharply writing down their most problematic assets.

The significant efforts made to overcome the imbalances that had built up have, however, contrasted with the underlying doubts and uncertainty on the sector remaining on financial markets. Last November, the markets' lack of confidence in the strength of the Spanish financial system was exacerbated by the second wave of the sovereign debt crisis, which affected Ireland above all, but whose effects spread to other euro area economies.

Worsening confidence and the subsequent difficulties in obtaining funding on international markets have made it necessary to adopt new measures to ensure that the progress made over the past 18 months in restructuring savings banks is successfully concluded. Such measures have included the creation of the FROB (the Fund for the Orderly Restructuring of the Banking Sector) in the summer of 2009, the publication of the results of the stress tests and the reform of the Savings Banks Law in July 2010. The new measures seek to step up and deepen the changes already achieved.

The first of the new measures adopted was the call last November by the Banco de España for an additional transparency drive on the part of credit institutions involving the publication of detailed and itemised data on exposure to real estate development and construction. These data were published in the closing days of January.

Also, the government has decided to go a step further with its approval on 18 February 2011 of a Royal Decree-Law that will ensure improved solvency levels not only at savings banks but across the entire financial system, prompting those institutions that need it to raise capital either from the private sector or, when this is not possible, through FROB funds. It thus seeks to dispel any remaining doubts over the strength of the Spanish financial system, which can thus continue to meet solvent demand for credit from households and businesses.

2 The problems of the savings banks sector

2.1 Structural problems

Some of the problems of savings banks are associated with their singular legal status. Firstly, they have a complex and rigid governance structure, which is not conducive to the application of international corporate governance best practices. And secondly, they face legal restrictions when seeking to obtain Tier 1 capital through means other than retaining profits. Table 1 sets out these structural difficulties along with the measures - which are analysed later in this note - adopted to resolve them.

TABLE 1. SAVINGS BANKS. STRUCTURAL DIFFICULTIES AND MEASURES ADOPTED

STRUCTURAL DIFFICULTIES	MEASURES ADOPTED
Difficulty obtaining capital	Legal reform allowing capital to be issued
Complex legal structure	New Savings Banks Law

While savings banks pursued a traditional business model, based on proximity to their region of origin, the marketing of non-complex banking products to their customers and the pursuit of moderate growth strategies, obtaining capital through the capitalisation of profits generated was sufficient to fund their activity. In these circumstances, the restrictions associated with their particular governance arrangements did not significantly hamper their normal development. However, as savings banks progressively extended the range and complexity of their business, the full extent of these structural difficulties became apparent.

2.2 Imbalances that have built up in the business

During the long economic upturn (1996-2006) prior to the crisis in the summer of 2007, a number of savings banks progressively built up various imbalances whose significance became manifest when the macroeconomic environment changed.

The two problems seen to be significant are high exposure to real estate development and construction, and dependence on the wholesale funding markets. In addition, the sector’s excess capacity, given the reduction in the financial services demanded by the real economy; the fragmentation of the sector, which is divided into a large number of savings banks; diminishing profitability, due essentially to oversized structures; the increase in non-profitable assets; and the higher cost of funding became also evident. Table 2 summarises these imbalances in the business, and the measures adopted (detailed elsewhere in this note) that most directly contribute to alleviating or resolving them.

TABLE 2. SAVINGS BANKS. IMBALANCES BUILT UP

IMBALANCES BUILT UP	MEASURES ADOPTED
Real estate development exposure	Provisions and transparency
Dependence on wholesale funding	Transparency and greater size
Excess capacity	Restructuring plans
Small average size	Adjustment through merger and concentration
Loss of business profitability	Restructuring plans

Occasionally, retail mortgage insolvency exposure has been singled out as one of the problems brewed by the expansionary stage, akin to US subprime mortgages. But the true scale of this problem in Spain is not significant. The behaviour of retail mortgages in Spain is much better than that of any of the other credit portfolios that institutions hold. Annex 1 analyses this issue in greater detail.

3 Measures adopted to resolve the problems

3.1 The creation of the FROB

One of the main measures adopted to set about restructuring the banking sector was the creation of the Fund for the Orderly Restructuring of the Banking Sector (FROB), approved as a result of broad consensus among the different parliamentary political groupings. The FROB was set up in June 2009 with a dual purpose: first, to pave the way for merger and concentration processes involving viable institutions, reinforcing the solvency of the resulting institution and providing for its restructuring; and second, to provide a rapid and effective solution for credit institutions that have not been able to overcome their difficulties and have ceased to be viable. This second purpose has only been relevant in the case of CajaSur, while the first purpose has allowed eight merger processes to be approved. In total, aid provided by the FROB to date amounts to €11.56 billion, little more than 1% of GDP.

As will be analysed elsewhere, the merger and concentration processes, in many cases backed by the FROB, have contributed to resolving or alleviating several of the aforementioned imbalances at savings banks: the overall size of the sector has been reduced, as has its fragmentation; access to funding markets has been improved; the capacity to operate more efficiently and profitably has been strengthened; and the writing down of troubled assets has been accelerated.

Significantly, the FROB has also demonstrated the necessary flexibility to support merger and concentration processes irrespective of their legal format. Thus, both in the case of mergers between savings banks, and in agreements setting up institutional protection systems (IPSs), the FROB has enjoyed the legal capacity to implement such support. IPSs, sometimes called “de facto mergers”, are an arrangement whose effects are fully equivalent to those of mergers.

3.2 The new Savings Bank Law

The reform of the savings bank law, implemented through Royal Decree-Law 11/2010, probably the most far-reaching reform since 1977 of the legal regime governing savings banks, addressed the above-mentioned structural weaknesses of the savings bank sector: governance, and the capacity to obtain Tier 1 capital on the capital markets.

The reform opened up a whole range of new possibilities for savings banks, namely the raising of Tier 1 capital and the indirect pursuit of financial activity through a banking institution to which they shall transfer their financial business (and in which they shall hold at least 50% of the voting rights, or else they will lose their status as a credit institution, and must turn themselves into foundations focusing on welfare projects).

Savings banks that place voting stock with third parties, either directly or through a bank, shall be subject to closer surveillance and monitoring by financial agents, which will result in enhanced management. The reform also included specific elements aimed at professionalising the financial management of savings banks, with a reduction in the weight that publicly represented officials account for, regulation of the incompatibilities regime, aimed at enhancing corporate governance, and stricter requirements regarding professionalism and experience.

3.3 Reinforced transparency

In the summer of 2010 the Banco de España clearly stepped up the demand for greater transparency concerning the situation of all Spanish banks, as a key factor in retaining or restoring investor confidence. The stress tests coordinated at the European level were, in Spain, of far greater scope and involved much greater transparency than in the rest of the European Union. Over 90% of the total system, including all listed banks and all savings banks, were covered by the tests, not just the 50% required in Europe. Furthermore, more extensive and detailed information than was required under the common European framework was published in Spain, with particular attention to credit for real estate activities. Section 4.5 shows the effect this initiative had. A similar, coordinated, Europe-wide exercise will be repeated in spring 2011.

3.4 Amendment of the accounting rules on loan write-downs

Also in summer 2010, the Banco de España decided to amend the accounting regulations on loan write-downs (loan loss provisions) which is recognised as conservative and based on objective rules. The aim was three-pronged: first, to recognise the value of different real-estate collateral (grading it by type of asset), applying, out of precaution, significant haircuts and shortening the term over which provisioning had to be made for the overall exposure; second, increasing minimum provisions for foreclosed assets, which would not only depend on the updated value of appraisals, but also on the passage of time; and third, providing incentives to ensure that when loans are extended, greater margins of prudence are established and greater precaution is taken to ensure a realistic and updated valuation of the collateral.

4 Results obtained

4.1 Savings banks placed under administration

Since the international financial crisis broke over three and a half years ago, only two credit institutions in Spain, both of which savings banks, have gone into crisis and required application of the resolution mechanisms in place at the time for non-viable banks. The institutions involved were Caja Castilla-La Mancha (CCM) and CajaSur. In all, they accounted for only slightly more than 1% of the system's total assets.

- Caja Castilla-La Mancha (CCM). On 29 March 2009, within the traditional framework of action of the Deposit Guarantee Funds (DGF), it was agreed to replace the directors of CCM with others appointed by the Banco de España. Once restructuring was completed, CCM's banking business was finally integrated into the Cajastur group (which is part of the "Base" IPS) in September 2010. CCM restructuring operation received the following aid from the Savings Bank DGF: €2.48 billion under an asset protection scheme for second losses (provisions for insolvency previously created are consumed first), and an asset purchase operation involving the recognition of losses of €596 million, which may vary depending on the outcome of the disposal of the assets purchased. Further to this asset purchase, certain preference shares were redeemed and a temporary loan was repaid – both previously granted by the DGF -.

- CajaSur. This institution was seized on 21 May 2010, in accordance with the new FROB framework. The FROB provisionally took over management of the institution and, in 55 days, it oversaw the assignment of its business, by means of a competitive process, to BBK on 15 July. Final aid amounted to €392 million, instrumented through an asset protection scheme.

The resolution of the crisis at CajaSur benefited from the new FROB regulations, which provided for a much more flexible, swift and efficient solution than that agreed for CCM using the traditional DGF framework, in which any solution had to be approved by the Assembly and the regional Government.

4.2 Merger and concentration processes

a Processes without and with FROB aid

In 2010, most Spanish savings banks took part in merger and concentration processes, which reduced their number from 45 to 17 institutions. A total of 40 institutions, with assets accounting for 95% of the savings bank sector, participated in the 12 processes that took place.

TABLE 3. SCOPE OF SAVINGS BANK RESTRUCTURING

€ bn

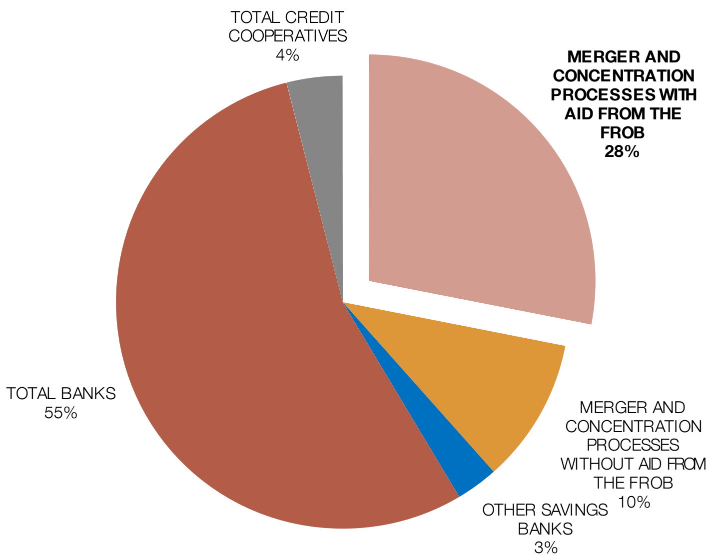
Savings banks	Participating institutions	Number of processes	Total assets (30.9.10)
Merger and concentration processes with FROB aid	33	9	886
Merger and concentration processes without FROB aid	7	3	326
Institutions placed under administration*	2	-	
Total restructuring	**40**	**12**	**1,212**
Other	**5**		**74**
Total savings banks **	**45**		**1,286**

* These two institutions are participating in merger and concentration processes

** CECA not included

One quarter of the processes were conducted without the need for FROB aid. Chart 1 shows FROB aid has been concentrated in processes involving the participation of savings banks whose assets account for 28% of Spanish deposit institutions' total assets.

CHART 1. SAVINGS BANKS THAT HAVE RECEIVED AID FROM THE FROB: COMPARISON WITH THE SYSTEM (% OF TOTAL ASSETS)



Tables 4 and 5 summarise merger and concentration processes that have not received (Table 4) and that have received (Table 5) aid from the FROB.

TABLE 4. SUMMARY OF SAVINGS BANK MERGER AND CONCENTRATION PROCESSES THAT HAVE NOT RECEIVED AID FROM THE FROB

INSTITUTIONS (1)	PROCESS	TOTAL ASSETS (Sep-2010)	
		Amount (€bn)	% OF TOTAL SAVINGS BANKS
La Caixa –Caixa Girona	Merger	271	20.8%
Unicaja-Jaén	Merger	35	2.7%
Caja 3	IPS	20	1.5%

(1) See list of institutions in Annex 2

TABLE 5. SUMMARY OF SAVINGS BANK MERGER AND CONCENTRATION PROCESSES WITH AID FROM THE FROB

INSTITUTIONS (1)	PROCESS	TOTAL ASSETS (Sep-2010)		AID FROM THE FROB (€m)
		Amount (€bn)	% OF TOTAL SAVINGS BANKS	
Banco Financiero y de Ahorros	IPS	345	26.4%	4,465
Base	IPS	126	9.6%	1,493 (2)
Catalunya Caixa	Merger	77	5.9%	1,250
Novacaixagalicia	Merger	76	6.0%	1,162
Banca Cívica	IPS	73	5.5%	977
Mare Nostrum	IPS	71	5.4%	915
Caja España-Duero	Merger	46	3.5%	525
BBK	Acquisition	45	3.5%	392
UNNIM	Merger	29	2.2%	380

(1) See list of institutions in Annex 2

(2) Cajastur also received aid from the Savings Bank Deposit Guarantee Fund: see section 4.1.

As can be seen in the above table, as at 15 February 2011, aid from the FROB amounts to €11.56 billion.

Accordingly, the creation of the FROB in 2009, and its capacity to support merger and concentration processes between institutions through the acquisition of preference shares, remunerated at market prices and redeemable within five years (extendable to seven years), has provided a boost to the rationalisation and restructuring of savings banks in Spain. The effects of these processes are described below.

b Some effects of the processes

Size

With the restructuring of the savings banks sector in 2010, the excessive fragmentation of this sector has been corrected. Average total assets per institution or group have risen from €29 billion to €76 billion, thereby reinforcing their ability to compete efficiently.

Capacity

The merger and concentration processes are also a means of addressing the problem of oversized networks and central services which, from an overall standpoint, had given rise to excess capacity in the sector and, from an individual standpoint, were weighing down on the ability of each institution to compete efficiently. The envisaged adjustments are significant, since they entail cuts of between 10% and 25% in the number of branch offices and between 12% and 18% in staff numbers.

In fact, the savings bank sector had already reduced its branch offices by 5% and its staff by 4% in relation to the peak levels reached during 2008.

Loan write-downs

The merger and concentration processes have also provided for extensive restructuring of participating institutions' balance sheets, since, through application of the convention of fair value in business combinations, savings banks have had to recognise, as at the merger date, capital losses on their loans and receivables and on foreclosed assets totalling €22 billion.

Other effects

In the near future, the merger and concentration processes must achieve other goals in order to justify themselves. Improved profitability and efficiency must be discernible once the processes take root and managers implement all the measures envisaged. The processes will contribute to improving savings banks' capacity to raise funds on the markets.

4.3 Balance-sheet restructuring in the 2008-2010 period[1]

The measures adopted have contributed to the provisioning drive savings banks have made in the past three years to comply with Banco de España accounting requirements, including the reform of write-down rules in the summer of 2010.

Thus, in addition to the capital losses of €22 billion recorded against equity in the merger and concentration processes, as described in Section 2 above, in the three years from 2008 to 2010

[1] The data offered in this note have been extensively checked, but they are not final since the external audits prior to the presentation of the audited financial statements for 2010 have not yet been closed.

(September 2010) savings banks recorded provisions of more than €23 billion with a charge to the profit and loss account for loans and assets received in payment of debts, compared with less than €10 billion in the previous three-year period. Further, the recognition of impaired assets during the same period led to the recording of an additional €7 billion, through use of the general provision that institutions had been funding since the Banco de España, in 1999, established the obligation to record this dynamic provision for use in cyclical downturns. In sum, since 1 January 2008 the savings bank sector has recognised in its books loan impairment losses amounting to around €52 billion.

The following section analyses in depth the write-downs recorded in the real estate development and construction portfolio, the lending segment of the savings banks sector that is subjected to the closest scrutiny by analysts.

4.4 Risks and write-downs in the real estate development and construction sector

Write-down efforts have focused particularly on the real estate development and construction sector. Savings banks' exposure to this sector reached high levels as a result of the strong growth it underwent in the years prior to the crisis. Table 6 details these exposures, including not only credit risk but also the amount of assets received in payment of debts (foreclosures).

Overall, with data to December 2010, savings banks' total exposure to the real estate development and construction sector amounted to €217 billion, €173 billion of which related to lending, and €44 billion to foreclosed assets or property received in payment of debts. Total potentially impaired loans (defined broadly so as to include doubtful loans, loans under surveillance and foreclosures) amounted to €100 billion, which accounts for 46% of the total exposure.

TABLE 6. SAVINGS BANKS' EXPOSURE TO THE REAL ESTATE DEVELOPMENT AND CONSTRUCTION SECTOR

€bn December 2010

	Exposure	% of exposure	% of total credit risk (2)
Credit risk (1)	**173**	**80%**	**18%**
Standard	117	54%	12%
Completed development	*50*	*23%*	*5%*
Development in progress	*26*	*12%*	*3%*
Urban and developable land	*22*	*10%*	*2%*
Other	*19*	*9%*	*2%*
Standard under surveillance	28	13%	3%
Completed development	*7*	*3%*	*1%*
Development in progress	*4*	*2%*	*0%*
Urban and developable land	*10*	*5%*	*1%*
Other	*7*	*3%*	*1%*
Doubtful	28	13%	3%
Completed development	*9*	*4%*	*1%*
Development in progress	*5*	*2%*	*1%*
Urban and developable land	*7*	*2%*	*1%*
Other	*7*	*3%*	*1%*
Foreclosures	**44**	**20%**	**4%**
Completed housing	*18*	*8%*	*2%*
Housing under construction and other (industrial buildings, offices, etc.)	*3*	*1%*	*0%*
Land	*23*	*11%*	*2%*
TOTAL EXPOSURE	**217**	**100%**	**22%**

(1) Included for these purposes are drawn down credit, financial guarantees and 50% of drawable credit. In the case of foreclosures, the book value of the loan at the time prior to the foreclosure or acquisition is reflected.
(2) Percentage of total credit risk (not only the real estate development sector) plus foreclosed assets.

The foregoing information is also broken down by type of asset or collateral: completed development, development in progress, demarcated urban and developable land, and other. The category "other" includes other land, property development awaiting a permit, collateral, guarantees and second mortgages.

It can be seen that the figure of €217 billion differs from some others made public on the risk exposure of savings banks to this sector. Annex 3 compares these figures.

Table 7 shows the level of provision coverage of potentially troubled exposures (those classified as doubtful, "standard under surveillance" and foreclosed) in the real estate development and construction sector.

TABLE 7. COVERAGE OF POTENTIALLY TROUBLED EXPOSURES IN THE REAL ESTATE DEVELOPMENT AND CONSTRUCTION SECTOR

	Exposure €bn	Specific provision €bn (2)	% exposure	Total provisions €bn	% exposure
Potentially troubled loans(1)	**100**	**31**	**31%**	**38**	**38%**

(1) Includes €28 billion of doubtful loans, €28 billion of standard loans under surveillance and €44 billion of foreclosures.
(2) Includes the provisions recorded to cover 100% of the loss incurred, as well as any additional losses recognised as a result of value adjustments in business combinations

As can be appreciated, the specific provisions set aside amount to 31% of the total of these exposures. If to this is added the amount of the general provision, the total provisions cover 38% of this portfolio. This percentage is very high if it is taken into account that, furthermore, most of the loans are secured by mortgages and that the figure of €100 billion includes €28 billion of standard loans under surveillance which, under international accounting standards, will in principle only require a precautionary provision.

If the amount of total provisions recorded (€38 billion) is compared with an estimate of the expected loss for the €217 billion real estate development and construction portfolio, calculated for an adverse stressed scenario with a very low probability of occurrence, like that used in the July 2010 stress tests, it is found that these provisions amount to 77% of that expected loss (an extremely high percentage if it is considered that accounting provisions have to be calculated on the basis of incurred, rather than expected, loss).[2]

It should also be noted that the protection which the provisions in place provide against a possible fall in the value of collateral or assets received in payment of debt is much higher than that apparently shown by the percentages in the foregoing table. That is to say, the provisions cover losses from much higher percentage falls in asset value than the percentages stated above. This is because of the safety margin provided by the fact that the loan amounts are nearly always lower than the value of the collateral (i.e. they have average “loan to value” ratios of 60%). As can be seen in Annex 4, the provisions of 38% set aside would suffice, in the example analysed, to absorb falls in value of up to 70% in the case of land.

In short, it can be concluded that savings banks have applied a very prudent approach in accounting for their exposures to the real estate development and construction sector, because:

a They have recognised as potentially troubled an extremely high percentage (46%) of their exposures in the real estate development and construction sector.
b One hundred percent of the losses incurred in this portfolio are now covered by provisions. Furthermore, the provisions also cover additional losses recorded in

[2] It should be noted, moreover, that savings banks have an aggregate “principal capital” ratio of 8.3%.

mergers as a result of application of fair value accounting (also included are value adjustments to accommodate current market circumstances in respect of illiquidity and risk premia and profit margins). The total provisions, including the general allowance, represent 38% of potentially troubled loans.

c If, despite the extensive recognition of losses carried out particularly in the last three years, it is considered that additional losses in exposure to real estate developers may arise in the future, the estimates made show that the provisions in place cover 77% of the expected loss in a hypothetical adverse stressed scenario with an extremely low probability of occurrence. The capacity to generate operating profit and potential profits on unrealised capital gains must be added to this percentage.

4.5 Effects of publication of the stress tests in July 2010

The initiative to conduct stress tests on many more than the required minimum of 50% of banks (in Spain more than 90% were tested, including all listed banks and all savings banks) and to provide more extensive information than officially required (for example, on real estate development loans) had two effects: one direct, in that it made it possible for all interested parties to obtain an accurate knowledge of the resilience of our system to adverse scenarios; and one induced, in that it provided a basis for the gradual opening up of funding markets to Spanish banks.

Results of stress tests

These stress tests demonstrated that, as a whole, Spanish banks are sound and able to absorb the potential losses derived from highly improbable extreme scenarios.

The level of capital set by Ecofin to determine whether banks passed the stress tests was a core (tier 1) capital ratio of 6%, i.e. 50% more than the legally required minimum. Under these conditions, the results showed that, in the stressed benchmark scenario, all Spanish banks passed the test. In the adverse stressed scenario, only four savings banks did not reach that minimum objective of 6%. It is important to realise that, if the stress test had been carried out on the sample of banks required at European level (50% of the system, which would include only the two largest commercial banks and the largest saving bank), no Spanish bank would have failed to meet the levels set.

Effects of publication of the results

The publication of the tests immediately reduced the uncertainty which some financial agents had been showing towards the Spanish banking system. As a result, Spanish banks saw opportunities gradually emerge to access the funding markets and they took advantage of them to improve their funding structure. This phase of recovery in confidence was, however, interrupted in November 2010, with the outbreak of the second wave of the sovereign debt crisis in some countries, as will be seen later on.

4.6 Dependence on wholesale funding

The measures taken so far have not managed to establish a definitive basis for resolving the problem of excessive dependence on the wholesale market, a situation which, because of its nature, does not lend itself to rapid solutions, but rather must be tackled gradually. This requires management measures which banks are implementing through their business plans and, basically, a definitive recovery of institutional investors' confidence in the Spanish banking system. A large part of the measures described earlier (merger and concentration processes, balance sheet restructuring, transparency) are aimed at this objective: that our banking system receives the confidence and credit commensurate with its situation.

However, the extent of this problem has to be properly gauged. To do this, savings banks' regular funding requirements have to be known and compared with the regular funding sources. **Table 8** gives this analysis, showing the funding structure of the sector.

TABLE 8. FUNDING STRUCTURE OF SAVINGS BANKS

€bn December 2010

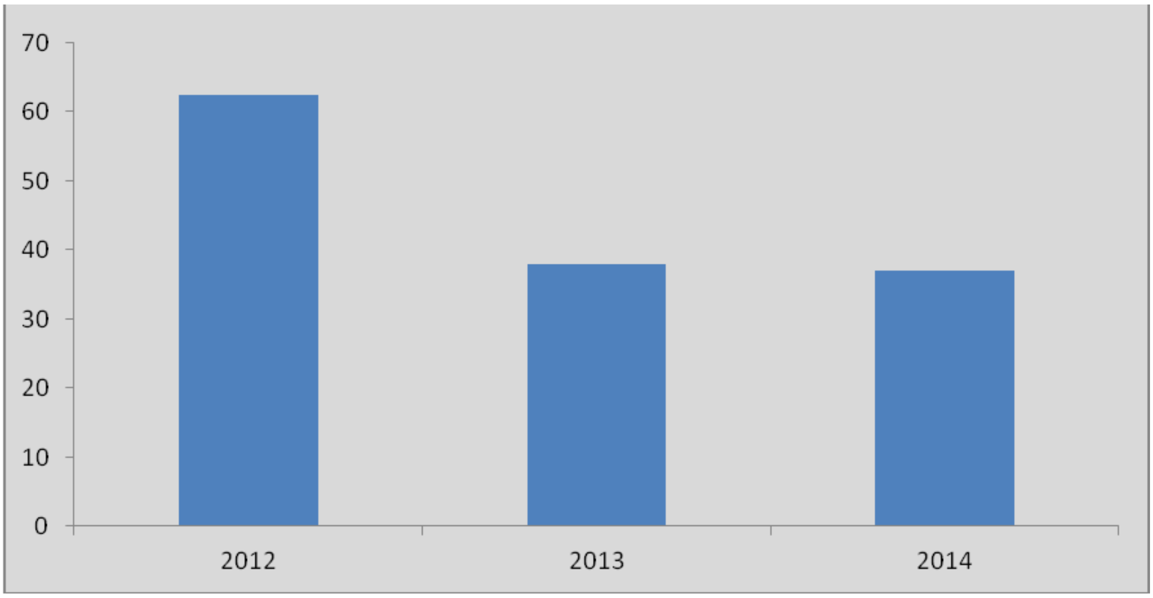
BALANCE SHEET OF THE SAVINGS BANK SECTOR (1)			
Loans and advances to other debtors (2)	870	Own funds	47
Investments	30	*Funding*	
Other assets, net	5	*between 1 year and 2 years*	*62*
		between 2 and 5 years	*109*
		more than 5 years	*102*
		Retail funding (3)	590
Regular funding requirements	***904***	***Regular funding sources***	***911***
Liquid securities	117	Wholesale funding with maturity of less than 1 year (4)	129
Balances with central banks	19		
Total	***1,040***	***Total***	***1,040***
Surplus on regular funding	**7**		

(1) Includes CECA and commercial banks forming part of savings bank groups.
2) Not including loans sold through securitisation.
(3) Deposits and financial instruments placed in the network.
(4) In addition to €53 billion of issues of securities and notes with terms below 1 year, it includes net interbank position, wholesale payables and ECB funding.

It can be seen that the regular funding requirements amount to €904 billion and are funded, at maturities over one year, by various means (own funds, wholesale funding with maturity of more than one year, etc.) for an amount of €911 billion. From another standpoint, the €129 billion of wholesale funding scheduled to mature in 2011 and the €136 billion of liquid banking book assets (securities and asset-side transactions with central banks) result in a regular funding surplus of €7 billion for balance sheets of €1,040 billion. To look at this from another potentially useful standpoint, since the wholesale funding scheduled to mature in 2011 amounts to €129 billion, and the liquid banking book assets (securities traded on secondary markets and asset-side transactions with central banks) amount to €136 billion, savings banks could, with these funds alone, weather a whole year of adverse international bond markets that is highly improbable to occur.

Regarding the wholesale funding with terms of more than one year, Chart 2 shows the scheduled maturities in the period 2012-2014.

CHART 2. WHOLESALE FUNDING OF SAVING BANKS (€bn). MATURITIES IN 2012-2014.



The chart shows that in the coming years the medium-term wholesale funding of savings banks matures in a staggered and uniformly distributed fashion.

Consequently, this problem of savings banks' dependence on wholesale funding is adequately identified and contained, since it is a medium-term question and not one prone to unexpected bottlenecks; moreover, the problem is tending to abate gradually. However, it is matter that must continue to be managed so as to gradually improve savings banks' financial structure.

The new measures to cope with the current situation, which are described in Section 5, aim to help disseminate a knowledge of the precise limits of this problem and to strengthen the conviction of third parties that Spanish banks have written down their loans appropriately and have a satisfactory level of solvency. This should help to open channels of funding which are currently not readily available.

5 New measures to cope with the current situation

The measures adopted so far have had highly positive results for the savings bank sector in Spain, as described in Section 4, since they addressed structural problems and business imbalances that had been building up.

However, in November 2010 the second wave of the sovereign debt crisis, with its epicentre in Ireland, triggered a fresh outbreak of mistrust in the financial markets, which again became inaccessible to many savings banks and, to a lesser extent, commercial banks.

This situation obliged the authorities to respond again, this time in two ways: firstly, they bolstered the requirement of transparency, so as to enable the banks themselves to dispel fresh doubts about their strength in the only way possible, namely offering detailed information on their risk exposures and provisions; and secondly, they instituted regulatory reform to ensure that the level of solvency rose generally throughout the sector, whether by raising capital from third parties or, failing that, by resorting to capital contributions from the FROB (Fund for the Orderly Restructuring of the Banking Sector) for a limited period of time.

The ultimate objective of these measures is to instil trust in all international financial market participants regarding the situation of the Spanish banking system, so as to recoup the necessary confidence and certainty as to its ability to continue contributing effectively to the intermediation of financial flows in our economy.

5.1 More transparency

Following the boost given to transparency by the Banco de España in July 2010 when it decided to publish extensively the results of the European stress tests, in November 2010 the Banco de España decided to ask savings banks to publish accurate information on the two points customarily highlighted by analysts as the main weaknesses of our banking system: the exposure to the real estate development and construction sector; and the volume of wholesale funding and the liquidity situation. As a result, all the savings banks with wholesale funding made this information public in January 2011. Furthermore, on 18 January the Banco de España formally required all Spanish banks to include this information in their 2010 financial statements.

This note itself goes one step further in transparency by offering for the first time detailed additional information not published to date.

5.2 Royal Decree-Law on measures to strengthen the Spanish financial system

The Royal Decree-Law passed by the government last Friday on 18 February 2011 adopts a series of measures to strengthen confidence in the Spanish financial system and ensure its solvency. This objective is met by applying a very high solvency requirement. To do so, a new ratio additional to those already in place is established. To comply with it, “principal capital” of at least 8% of total risk-weighted assets must be held at any time (with a minimum in 2011 equal to those assets included in the calculation as at 31-12-2010). That requirement of 8% will be raised to 10% for credit institutions verified to be evidencing the following two conditions: their proportion of funding in wholesale markets exceeds 20% and at least 20% of their share capital has not been placed with third parties, if both conditions prevail, the risk is considered to be greater.

Also, the functioning of the FROB is reformed as follows. It is authorised to acquire stakes in banks’ share capital for a limited period of time to strengthen their own funds, on the condition that the bank implements a recapitalisation plan, with commitments relating to reducing overhead costs, to corporate governance and to other matters. In the case of a savings bank or a savings bank merger through an IPS, the whole of the lending activity will have to be transferred to a bank by the mechanisms stipulated in legislation (indirect exercise of financial activity or conversion into a foundation owning a bank).

6 Conclusions

The prolongation of the economic crisis has meant that, following a period of intense growth of activity which produced some specific problems in the Spanish savings bank sector, particularly concentration in the real estate development and construction sector, increased dependence on wholesale funding markets, excess capacity, excessive fragmentation and loss of profitability, it has been necessary to undertake an extensive restructuring and regulatory reform of the sector in the last year-and-a-half.

In this period savings banks have sharply written down their loans and foreclosed assets, have conducted a notable exercise in the transparency of their real estate exposures and their funding structure and have strengthened their capital by retaining a significant portion of their profits and by receiving FROB assistance in the required amounts in accordance with the plans approved by the Banco de España. Along with this, they have embarked on the most extensive process of concentration in the history of the Spanish banking system, which will bring notable improvements in efficiency and in ability to access the funding markets.

In November 2010 the sovereign debt crisis, with its epicentre in Ireland, exacerbated the doubts and uncertainties which international investors and markets normally harbour in such continuous periods of economic weakness, originating a contagion effect which gave rise, for example, to a notable widening of Spanish debt spreads and to a further halt in the recovery of confidence in the Spanish banking sector, particularly in savings banks.

Faced with this situation, the government approved last Friday another reform designed to further strengthen the solvency of Spanish credit institutions and promote the option whereby savings banks needing external capital can pursue their financial activity through a bank, since this structure is the most suitable for attracting investors. For those deposit institutions that do not reach the new levels of capital required, which are much higher than the current ones, and do not attempt to raise capital from third parties, there remains the alternative of receiving funds from the FROB. Both measures aim to strengthen confidence in our system and dispel any uncertainty as to its ability to face future challenges in the short, medium and long term.

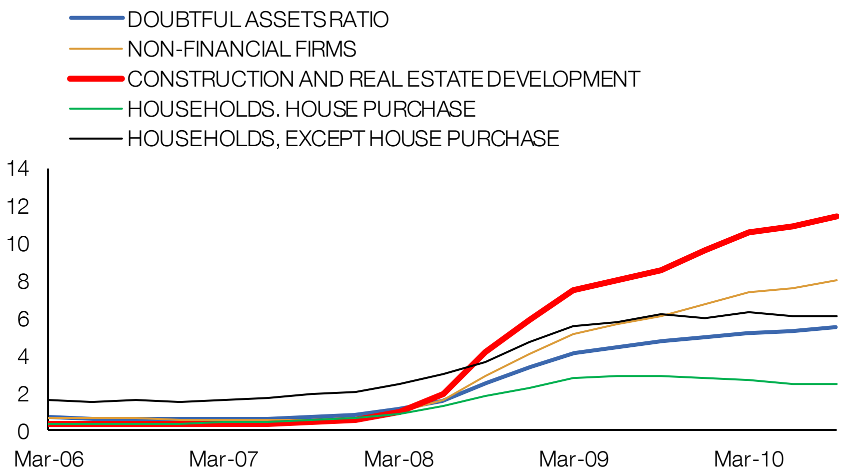
ANNEX 1

Situation of retail mortgages in Spain

It is sometimes said that one of the problems of Spanish savings banks is their high exposure to residential mortgage lending to individuals. This negative view of the exposure to retail mortgages in Spain is probably due to the extrapolation to the Spanish market of the effects that such exposures have had during the crisis in other countries. However, as shown by **Chart 3**, retail mortgages in Spain have outperformed credit institutions' other types of exposure. Thus, the doubtful assets ratio for retail mortgages stands at 2.5%, compared with 5.5% for credit as a whole and 11.6% for the real estate development and construction sector.

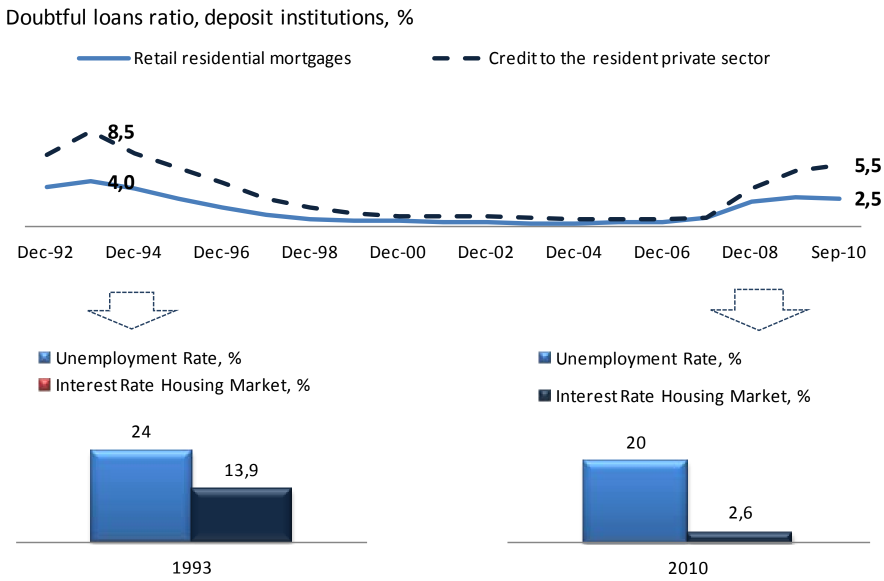
CHART 3. THE DOUBTFUL ASSETS RATIO OF RETAIL MORTGAGES COMPARED WITH OTHER SEGMENTS

Deposit institutions. Latest data: Sep-10, %



This relatively better performance by retail mortgages in Spain has stood the test of time. For instance, **Chart 4**, with data from the last 20 years, shows that this performance is similar to that seen in the 1992-1993 crisis. Although the unemployment rate at that time reached very high levels (24%) and interest rates stood at levels of 14%, considerably higher than current ones, the doubtful assets ratio remained, as at present, at low levels compared with that for total lending.

CHART 4. DOUBFUL ASSETS RATIO FOR RETAIL MORTGAGES, UNEMPLOYMENT RATE AND MORTGAGE INTEREST RATES



For socio-cultural and economic reasons, and because of the lending standards applied to most loans and the legal arrangements for the foreclosure of assets held as collateral (foreclosure does not extinguish the debt), the retail mortgage segment in Spain is particularly resilient in a crisis such as the present one.

Consequently, although savings banks do admittedly devote two-thirds of their activity to housing-related business, the latter includes very different segments from the standpoint of risk. Specifically, lending to individuals for house purchase secured by a mortgage, which represents slightly more than 45% of their private-sector lending, is on average an asset of very sound quality.

ANNEX 2

Institutions participating in merger and concentration processes

1 Mergers without aid:

La Caixa: La Caixa and Girona

Unicaja: Unicaja and Caja Jaén

Caja 3: CAI, Círculo de Burgos and Badajoz

2 Mergers with aid:

Banco Financiero y de Ahorros (Júpiter): Caja Madrid, Bancaja, Ávila, Segovia, Rioja, Laietana and Insular de Canarias

Base: Cajastur (includes CCM), CAM, Cantabria and Extremadura

Catalunya Caixa: Catalunya, Tarragona and Manresa

Novacaixagalicia: Caixa Galicia and Caixa Nova

Banca Cívica: Caja Navarra, Caja Canarias, Burgos and Cajasol-Guadalajara

Mare Nostrum: Cajamurcia, Penedés, Sa Nostra and Granada

Caja España-Duero (Espiga): Caja España and Caja Duero

BBK: Cajasur (acquisition)

Unnim: Sabadell, Terrassa and Manlleu

ANNEX 3

Savings banks' exposure to the real estate development and construction sector. Comparison with other published data

Comparison with the data published in the stress tests of July 2010

In Section 4 of this note (Table 6) the savings banks' total exposure to the real estate development and construction sector amounts to €217 billion. It can be seen that this figure is approximately €86 billion lower than the figure for this exposure used in July 2010 stress tests (€303 billion). In addition to the effect of natural developments in the portfolio (€-10 billion), the remainder is accounted for by the process of greater transparency gradually implemented from that date by institutions and the Banco de España involving the use of stricter methods of allocation to each portfolio, so that they are closer in line with the actual exposure and the nature of the loan and the customer. For instance, approximately €27 billion was allocated to civil engineering and public works, €16 billion to large corporations with mortgage security and €33 billion to SMEs with mortgage security[3].

Table 9 shows these figures and, in addition, calculates the effect this more detailed classification would have for the purposes of the stress test calculations.

TABLE 9. Comparison of data on exposure to the real estate development and construction sector as at 31.12.2010 with data published in the July 2010 stress tests.

€ bn

Date	Portfolio	Exposure	Expected Loss	% EL
December 2009 (stress test)	Property developers and foreclosures	303	55	18%
December 2010	Real estate developers	173	33	19%
	Foreclosed real estate assets	44	16	36%
	Subtotal: Real estate developers and foreclosed real estate assets	*217*	*49*	*23%*
	Civil engineering	27	2	8%
	SMEs with mortgage security	33	3	9%
	Large corporations with mortgage security	16	1	6%
	TOTAL	293	55	19%
Change in the portfolio		**-10**		

[3] A typical transaction of this nature is a loan extended to an industrial firm, secured by a mortgage on the industrial building in which its production facilities are situated. When the stress tests were performed in July 2010, for reasons of prudence, exposures of this type were assigned to sectors on the basis of the mortgage security and not on the basis of the productive activity and economic risk of the debtor firm. During the second half of 2010, this information has been refined to better reflect the exposure.

As can be seen in the table, this improvement in the assignment of exposures to portfolios according to their type does not have significant effects on the expected loss calculations in the stress tests or on the provisioning estimates.

Indeed, in the stress tests of July 2010, under the adverse scenario, an expected loss of €55 billion was calculated, 18% of the total exposure of €303 billion to the real estate development and construction sector. If we consider the reassignment of loans to the various portfolios, the sum of the expected loss on the various resulting tranches - calculated using the same loss parameters with data from December 2010 and which, as indicated in the footnote on page 9, are provisional figures that are extensively tested though still not audited - is also €55 billion, which represents 19% of the total exposure, 1 pp up on the above-mentioned 18%.

Comparison with the data published by the savings banks in January 2011

Aggregating the data presented by each institution, the savings banks have published a total figure for exposure to this sector of €205 billion. This value is close to the figure of €217 billion considered in this note. The bulk of the difference is accounted for by the divergent data presentation criteria: for example, the data presented in this note include undrawn exposures, such as drawable amounts and financial guarantees, which have not been explicitly disclosed by institutions, and the amounts of the foreclosed assets are presented, for the purposes of the exposure considered in this note, at the amount of the loan immediately prior to foreclosure.

Comparison with the data published in the Boletín Estadístico and the Financial Stability Report

The Banco de España's *Boletín Estadístico* publishes the data on the savings banks' lending to the real estate development and construction sector. The latest available figure relates to 30 September 2010 and places this lending at €230 billion. The difference from the amount presented in this report (€173 billion) is due to three factors: the figure published in the *Boletín Estadístico* does not include drawable amounts or bank guarantees (€14 billion); it covers the real estate development and construction sector in a broad sense of the term, i.e. it includes all the activities of those sectors not strictly related to housing construction (€66 billion); and in 2010 Q4 the real estate development and construction portfolio declined by €5 billion.

Although only data for all deposit institutions were published in the Financial Stability Report, without a breakdown of the data corresponding to the savings banks sub-sector, the data published in this report for deposit institutions as a whole are the same as those published in the *Boletín Estadístico*.

ANNEX 4

Analysis of the implied falls in the value of assets in the assumptions used for the expected loss calculation

Section 4 of this note analysed the high degree of provisioning of exposures to the real estate development and construction sector which had been achieved by the savings banks sector in December 2010. Specifically, the provisions represented 77% of the expected loss in the adverse stressed scenario and 38% of potentially troubled loans.

It was also pointed out that the protection afforded by the provisions recorded due to any possible falls in the value of the assets given as collateral or received in payment of debts is considerably higher than that apparently shown by the aforementioned percentages. That is, the provisions cover losses deriving from percentage falls in the value of the assets which were considerably higher than said percentages. That is due to the safety margin provided by the fact that the exposures are practically always granted for lower amounts than the value of the collateral (that is with loan-to-value ratios reported by the institutions to be at around 60% on average, far less than 100%).

This appendix offers some examples in this respect.

TABLE 10. EXAMPLES OF IMPLIED FALLS IN PRICES IN EXPECTED LOSS CALCULATIONS

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	INITIAL DATA		EXAMPLES				
Completed housing + foreclosures	LTV (1)	LGD (average used) (2)	Value of asset to be financed (3)	Amount of loan granted (LTV) (4)=(1)*(3)	Loss given default (LGD) (5)=(4)*(2)	Amount recovered (6)=(4)-(5)	Implied fall in price (7)=[(3)-(6)]/(3)
Completed housing	75	20	100	75	15	60	**40%**
Housing under construction	70	22	100	70	15	55	**45%**
Land	65	54	100	65	35	30	**70%**
Other collateral and guarantees	N.P	75					
Total real estate development and construction sector		**38**					

It is a matter of appropriately assessing the degree of "severity" used to calculate the gross impairment (expected loss) which may be generated by the assets, in order to appreciate whether or not a sufficiently adverse change is included in the price of the underlying assets (housing and land), should they be sold after foreclosure. From Table 10 it can be deduced that the "severity" parameter – loss given default (LGD) – of 38% used to calculate these expected losses (PD and LGD), implicitly means that, if and when the asset is sold, it is disposed of with a decline in the price of 40% for completed housing, 45% for housing developments under construction and 70% for land.

Table 10 starts from LTVs (ratio between the loan granted and the value of the mortgaged asset) of 75%, 70% and 65% for completed housing, housing under construction and land, respectively.

These values were obtained from the data reported by the institutions and a prudential adjustment was applied to them.[4] Similarly, the LGDs are those used in the European stress test exercise published in July 2010. On the basis of these data, it is possible to calculate the implied fall in value of each type of mortgaged asset used to calculate the expected loss in the adverse scenario. The procedure used for completed housing is explained below.

- The starting value for completed housing is 100, which is going to be financed by a credit institution by means of a mortgage loan.
- As the average LTV assigned to this type of asset is 75%, the loan which will be extended for said asset will be 75.
- If this loan is not repaid, the loss of 20% that the institution would have, would be the amount of the loan (75) multiplied by the LGD (20%), that is, 15. Consequently, the amount that the institution will recover is 60 (75-15).
- As the appraisal value of the asset was 100 and the institution recovers 60, the implied fall in the value of the asset is 40 (100-60); that is, 40%. Consequently, an LGD of 20% is equivalent to an average fall of 40% in completed housing prices.

Likewise, after applying similar calculations to housing under construction and land, the discounts used to estimate the gross impairment in the stress tests can be obtained, which represent declines of 45% and 70%, respectively. In order to appreciate their "severity", it should be taken into account that in Spain completed housing, on the available statistics, had at the end of 2010 posted an average fall of around 10% in its estimated nominal value and of 15% in its real value since end-2007.

To conclude, the savings banks have made considerable efforts to report their exposure, recognise losses and write down their most complex portfolio, real estate development and construction. They have achieved a very high level of provisioning, not only for the expected loss estimated in a hypothetical adverse scenario but also for potentially troubled lending (doubtful loans, standard loans under surveillance and foreclosures).

[4] For example, the average LTV for finished housing reported by Spanish credit institutions is 60%. For reasons of prudence, in the stress tests it is assumed that loans on finished housing which become troubled have an LTV of 75%, in order to factor in the assumption that defaults on loans granted more "generously" tend to be more frequent.