BANCO DE ESPAÑA
Eurosistema

The restructuring of the Spanish banking sector and the Royal Decree-Law for the reinforcement of the financial system

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1. Three crises

I. The international financial crisis

II. The economic crisis in Spain

III. The sovereign debt crisis

1. (I) The international financial crisis

- **CHARACTERISTICS:** began in summer 2007 and was exacerbated by the bankruptcy of Lehman Brothers. Collapse of major banks in several countries, increased volatility, widespread downturn in confidence and liquidity problems.

- **IMPACT ON THE SPANISH BANKING SYSTEM**:

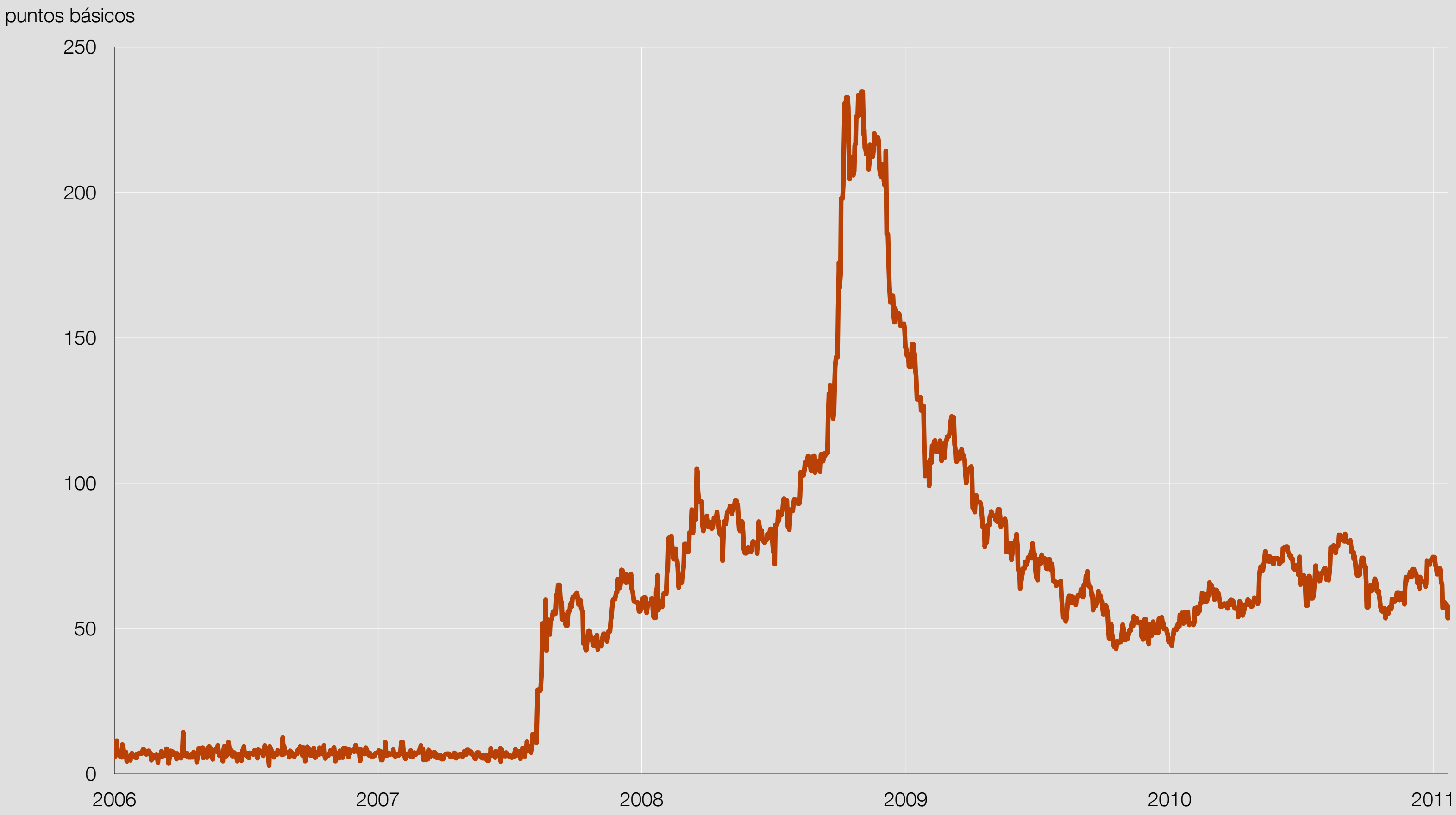
  - Impact on solvency: very limited, thanks to Spanish banks' business model (traditional retail banking) and to Banco de España regulation and supervision.

  - Impact on liquidity: global problems in the wholesale funding markets.

- **MEASURES ADOPTED:** aimed at ensuring liquidity: Fund for the Acquisition of Financial Assets, government guaranteed debt, provision of unlimited liquidity by the ECB.

1. (I) The international financial crisis

EURO AREA
12 MONTH INTERBANK SPREAD
(Euribor - Swaps Eonia)



1. (II) The economic crisis in Spain

- CHARACTERISTICS: “traditional” crisis, originating in the imbalances built up by the Spanish economy in the expansionary phase. The adjustment is exacerbated by the global economic recession.

- IMPACT ON THE SPANISH BANKING SYSTEM:

- Impaired asset quality (non-performing loans), especially in real estate development
- Evident excess capacity in the sector, along with the small average size of banks
- The budget deficit and structural imbalances gave rise to doubts over the sustainability of public finances
- The dependence on wholesale funding markets exposed Spanish banks to the tensions in these markets

-MEASURES ADOPTED:

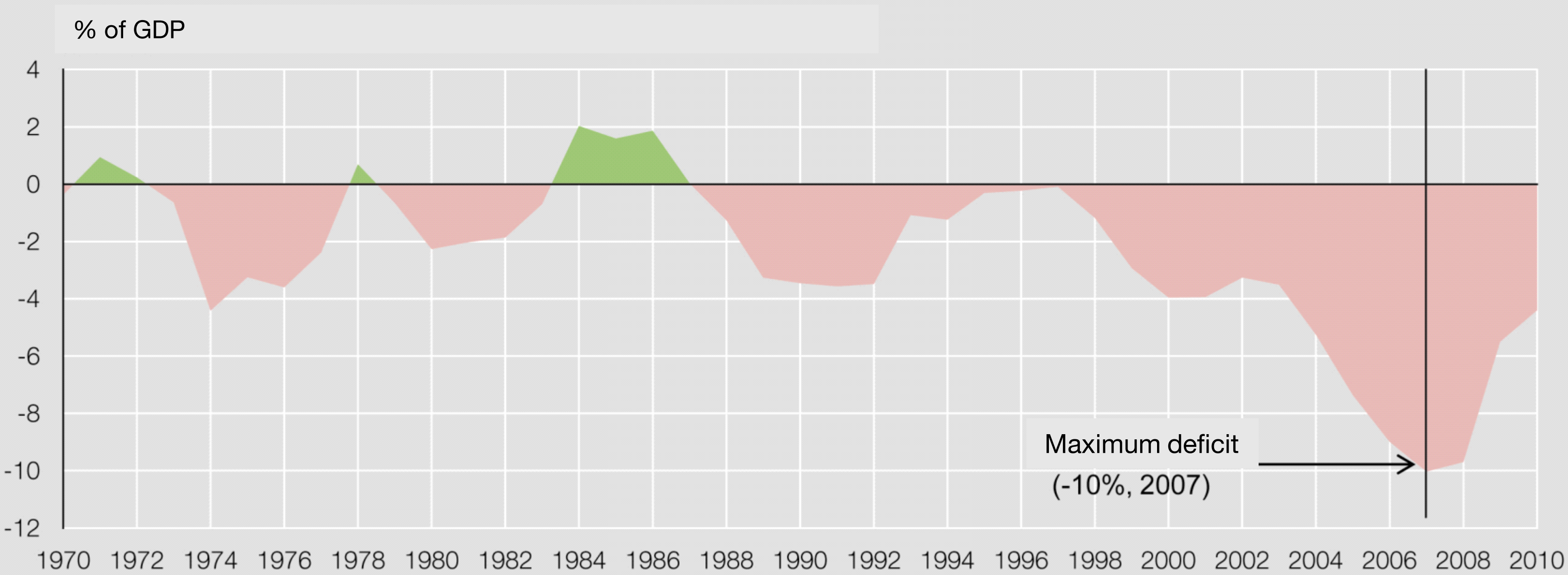
-Creation of the FROB

-Provides for flexible supervisory intervention and supports merger, concentration and restructuring processes aimed at strengthening the resulting institutions, at reducing excess capacity in the sector and at facilitating loan write-downs.

1. (II) The economic crisis in Spain

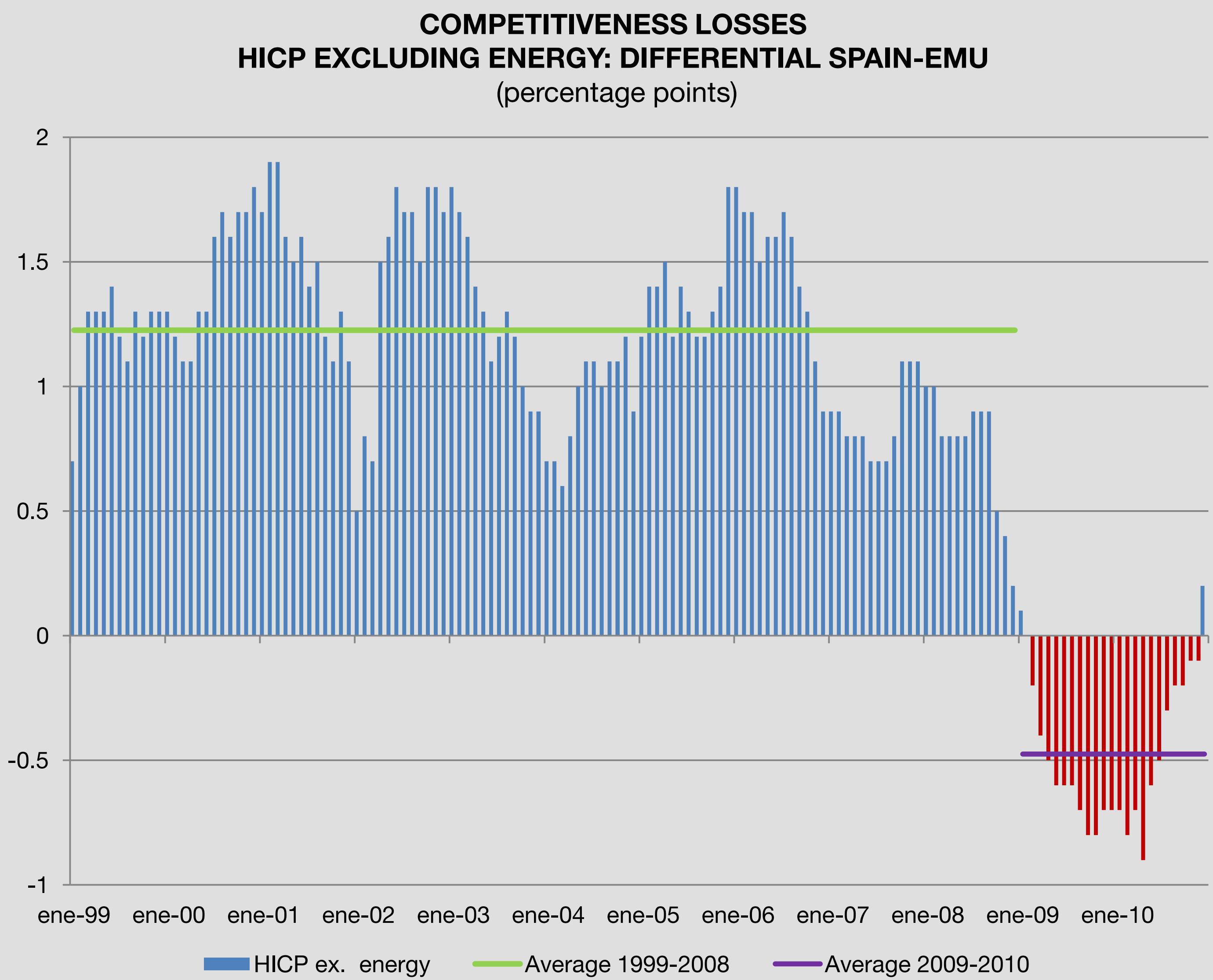
CURRENT ACCOUNT BALANCE

EVOLUTION 1970-2010



Source: Banco de España

1. (II) The economic crisis in Spain



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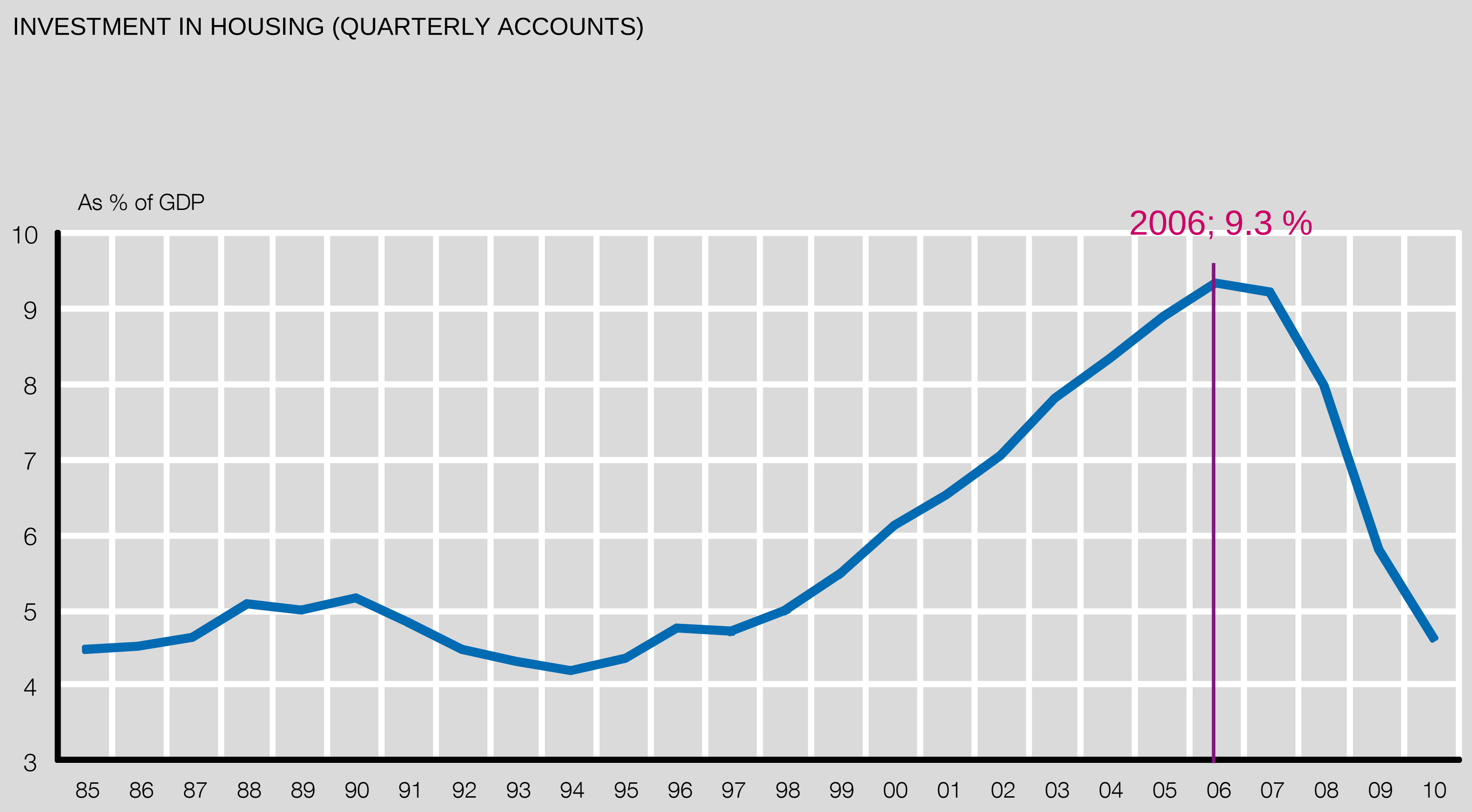
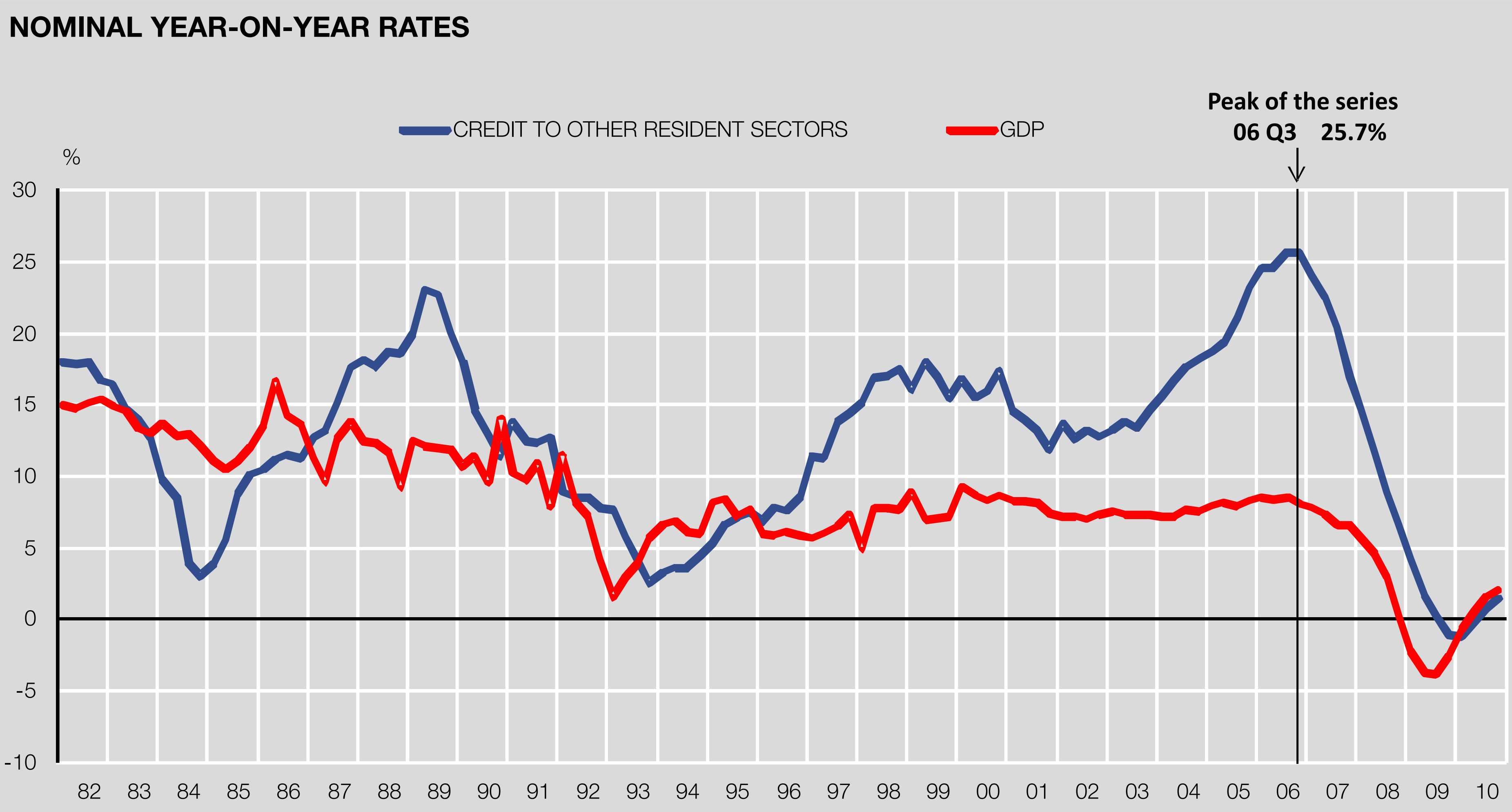


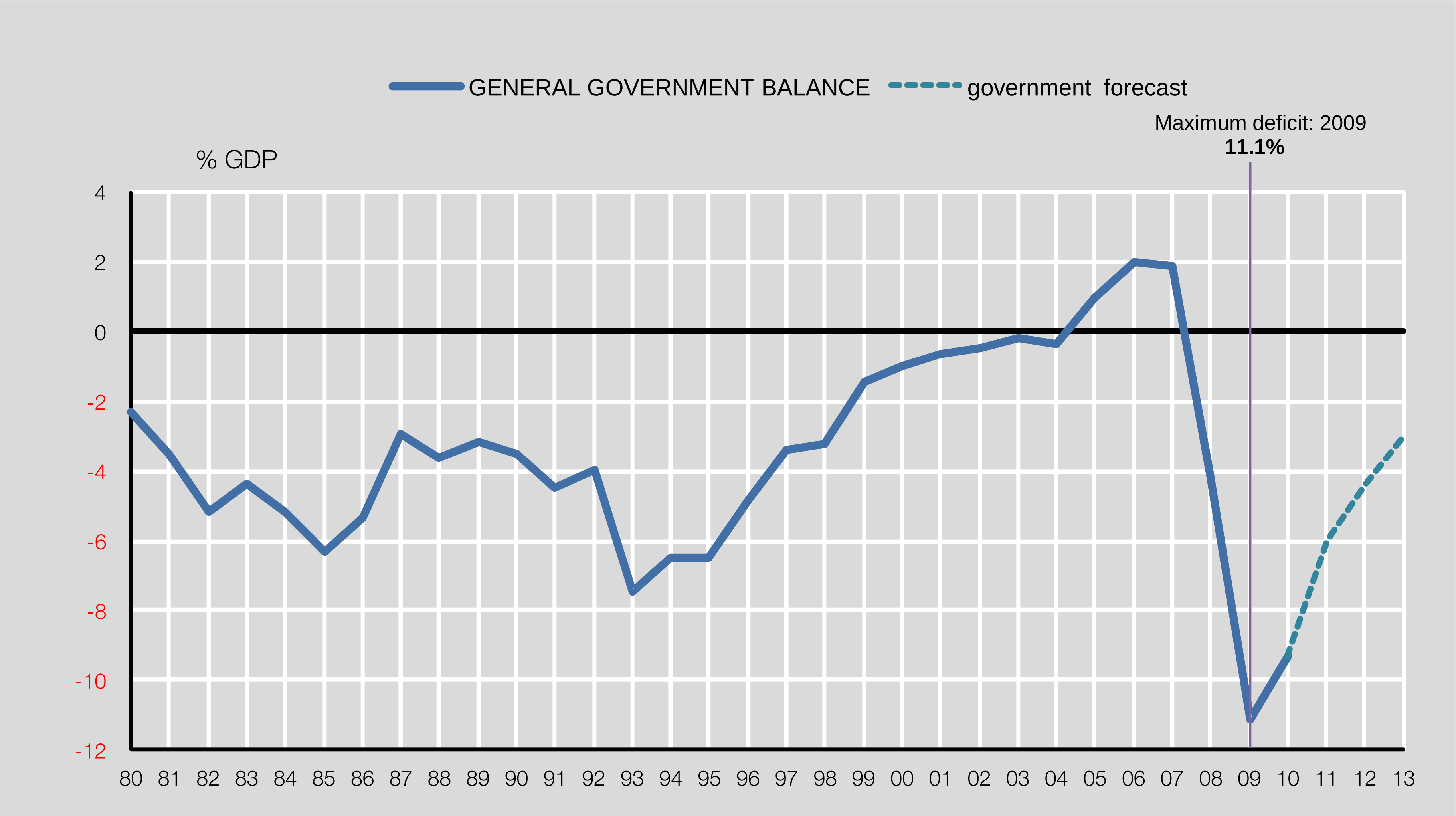
Sources: INE and Banco de España

1. (II) The economic crisis in Spain



Sources: Nationwide, Datastream, ECB and Banco de España

1. (II) The economic crisis in Spain



1. (III) The sovereign debt crisis

First episode: **the sovereign debt crisis in Greece**

-CHARACTERISTICS: doubts over the sustainability of Greek public finances fed through to other euro area economies and highlighted economic governance problems in the EU.

-IMPACT ON THE SPANISH BANKING SYSTEM: the lack of confidence in the soundness of the fiscal position entailed an increase in the cost of sovereign debt funding, which passed through to the banking sector (at the height of the tensions, the wholesale markets shut down)

- MEASURES ADOPTED:

- **Structural reforms:** budget deficit reduction plan, labour market reform.
- **Financial measures:** tightening of provisions, stress tests, restructuring of savings banks and reform of their regulatory framework
- **Measures at the European level:** creation of the European Financial Stability Facility, ECB public debt purchase programme

1. (III) The sovereign debt crisis

1. (III) The sovereign debt crisis

Second episode: **the sovereign debt crisis in Ireland**

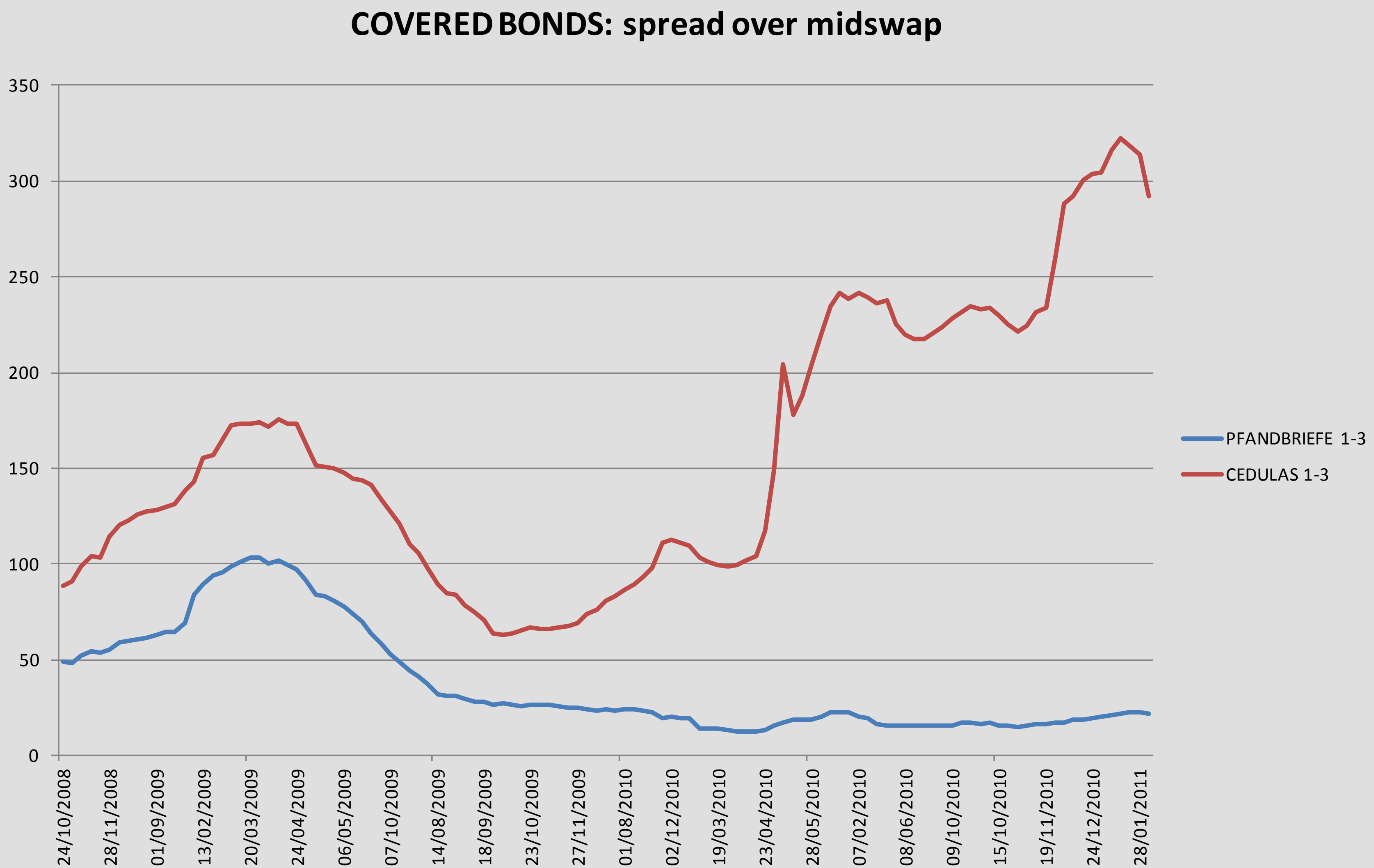
-CHARACTERISTICS: doubts over their public finances and lack of confidence in their financial system. Rapid contagion to other euro area economies, stress tests called into question and association of the real estate boom with banking sector problems.

-IMPACT ON THE SPANISH BANKING SYSTEM: heightening mistrust in public finances and in the soundness of the Spanish financial system. **Substantial increase in funding costs and difficulties in gaining access to wholesale markets.**

- MEASURES ADOPTADAS:

- **Structural reforms:** reform agenda pushed through (pensions, collective bargaining reform criteria)
- **Financial measures:**
  - More transparency: the institutions must give detailed information on their potentially problematic exposure and their funding.
  - Increase in capital requirements (8%-10%), with FROB backing when funds cannot be raised on the market
  - Banks encouraged to tap capital markets

1. (III) The sovereign debt crisis



In Spain, provisioning rules are straightforward and transparent

- The regulator sets **minimum criteria**, and **compliance** with these is **verified** by the **supervisor** and by banks' **external auditors**

  – *In other countries, provisions are generally decided by the banks and with the approval of the external auditors*

- For collateralised assets, significant haircuts are applied taking the lower of the loan value and the appraisal value (market value)

  – *In other countries it is not the habitual practice to apply these haircuts; rather, market value is considered*

In summer 2010, **provisioning rules** were tightened:

- The fundamental aim was to accelerate the coverage of non-performing loans and the potential impairment of foreclosures or assets received in payment of debt

Tightening of provisions

- **Acceleration of coverage requirement**: the portion not covered by the value of the collateral must be 100% covered within one year

- **Realistic haircuts to value the collateral**

  – *At the lower of the loan value and the appraised value:*

Borrower's principal dwelling:	*20%*
Rural land, offices, commercial and industrial premises and multi-purpose offices:	*30%*
Other finished housing (real estate development):	*40%*
Developable land parcels and building plots (real estate development):	*50%*

- **Incentives** were established **for banks to take foreclosed assets off the balance sheet**

  – *Provisions of 10% are set at the time of foreclosure taking the lower of the loan value and the appraised value. These rise to 20% and 30% after remaining for 12 and 24 months on the asset side of the balance sheet*

2. Asset valuation and funding

Provisions and asset valuation

- The **losses already incurred** are one hundred percent covered by **provisions**

    – Neither on the basis of their volume (which accounts for nearly 9% of GDP) or of their calculation (transparent, regulated and prudent) can it be sustained that there is a shortfall in the recognition of losses incurred

- For **potential losses under stressed scenarios,** scenarios with a **very low probability of occurrence** are considered.

Provisions and loan write-downs in savings banks' real estate development and construction portfolio:

- For savings banks, the Banco de España has determined 46% of the sector's exposure to real estate development and construction (€217 billion) as potentially problematic, comprising the following:

    – Standard loans under surveillance: €28 billion

    – Doubtful loans: €28 billion

    – Foreclosures: €44 billion

- The specific coverage set aside accounts for 31% of potentially problematic exposure (adding general provisions, coverage is 38%)

FUNDING OF THE SPANISH BANKING SYSTEM

Spanish banks' position at the onset of the crisis was reasonable in terms of their resort to the wholesale funding markets

- They retained a sound base of retail depositors
- And funded themselves on the wholesale markets at the longest-dated terms available

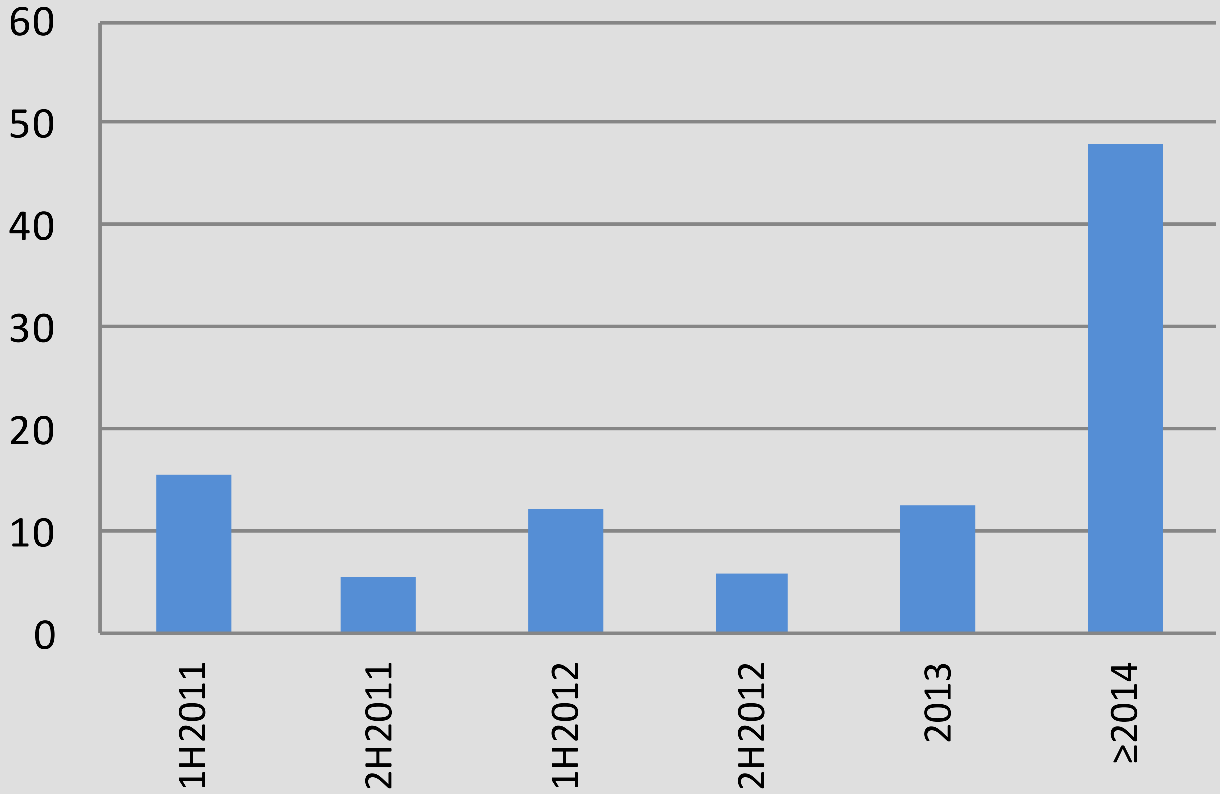
As indicated, the sovereign debt crisis in the euro area has resulted in the wholesale funding markets closing

- Spanish banks have resorted to Eurosystem funding to a greater extent than in the past
- But after peaking in the months prior to the publication of the July 2010 stress tests, the situation has tended to normalise
  - ***The data for January reflect a further reduction in applications for Eurosystem lending***
  - ***When the opportunity arises, Spanish banks tap the wholesale markets for funding***

Spanish banks should continue managing their funding requirements appropriately. However, the **structure of savings bank funding shows that stable disposable funding is slightly higher than stable funding needs**

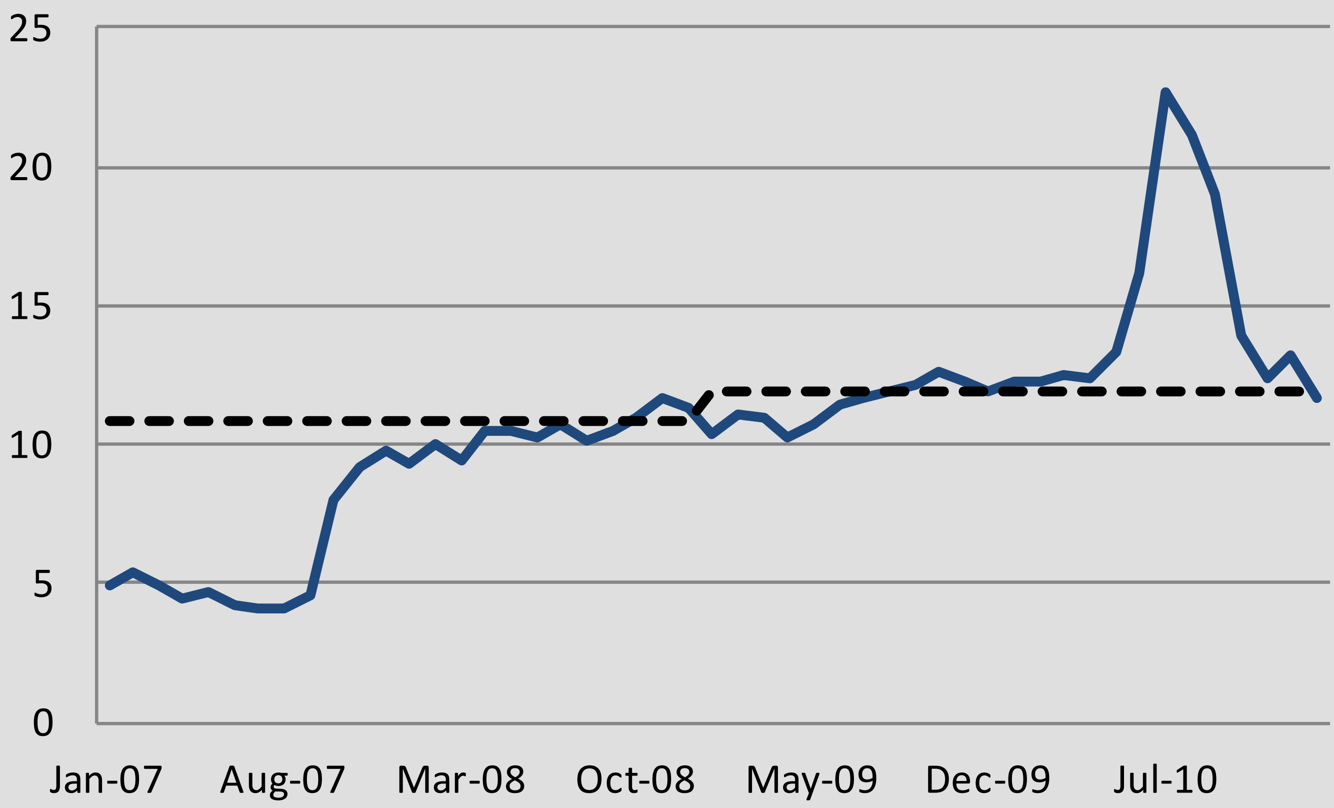
WHOLESALE FUNDING OF THE BANKING SECTOR

Maturity structure of debt issued on markets, including short-term paper. January 2011, %



2. Asset valuation and funding

Gross lending from the Eurosystem, %, compared to Spain's capital key. Latest data: Jan.2011



3. Scale of the real estate problem

- **Corrections in asset value are largely due to the loans related to the real estate development and construction sector,** whose doubtful assets ratio is growing significantly more than in the rest of the portfolio

- But **this portfolio segment,** which is where problems are concentrated, **accounts for only 22% of savings banks' credit to the resident private sector,** including foreclosures

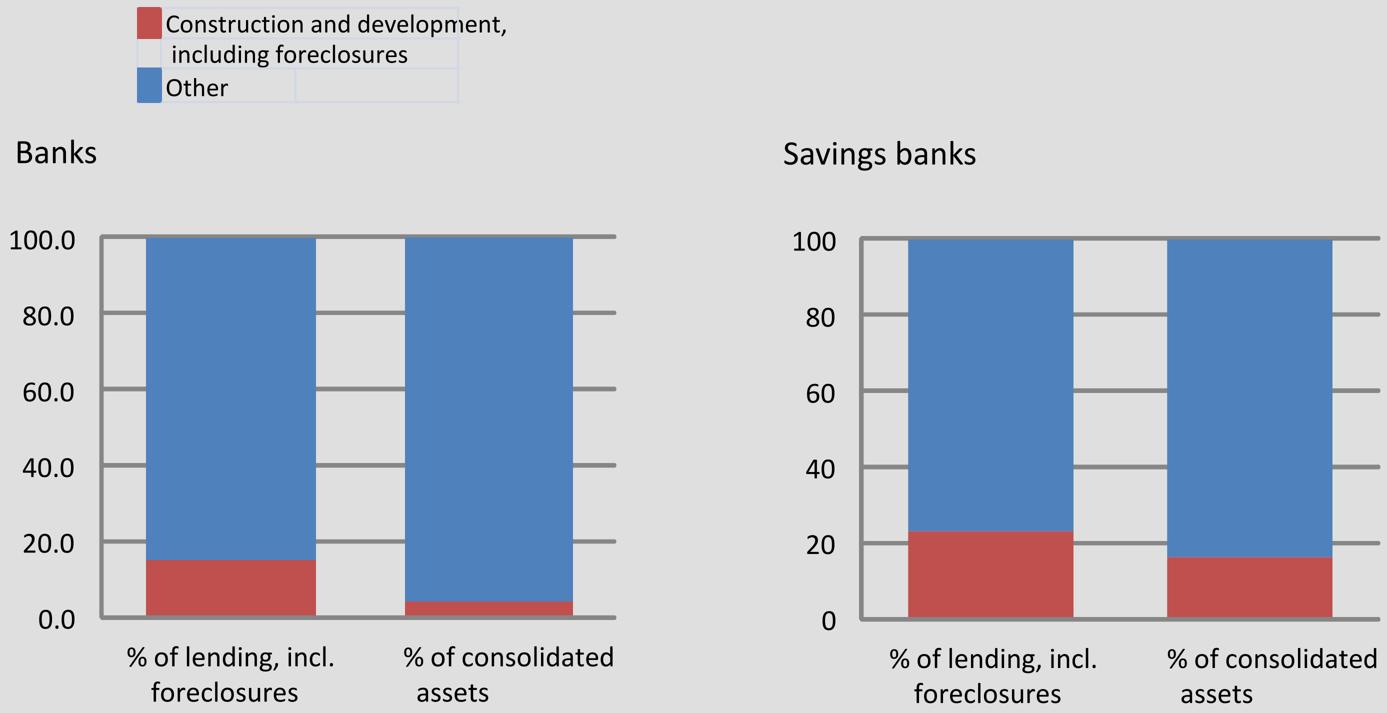
- Despite the real estate market adjustment in Spain, **the retail mortgage portfolio does not pose a problem**

  - Its default has historically been, and is, low
  - The portfolio's average LTV is 62%, and is distributed uniformly across institutions
  - The mortgage business in Spain is straightforward and banks have additional guarantees on the mortgaged asset

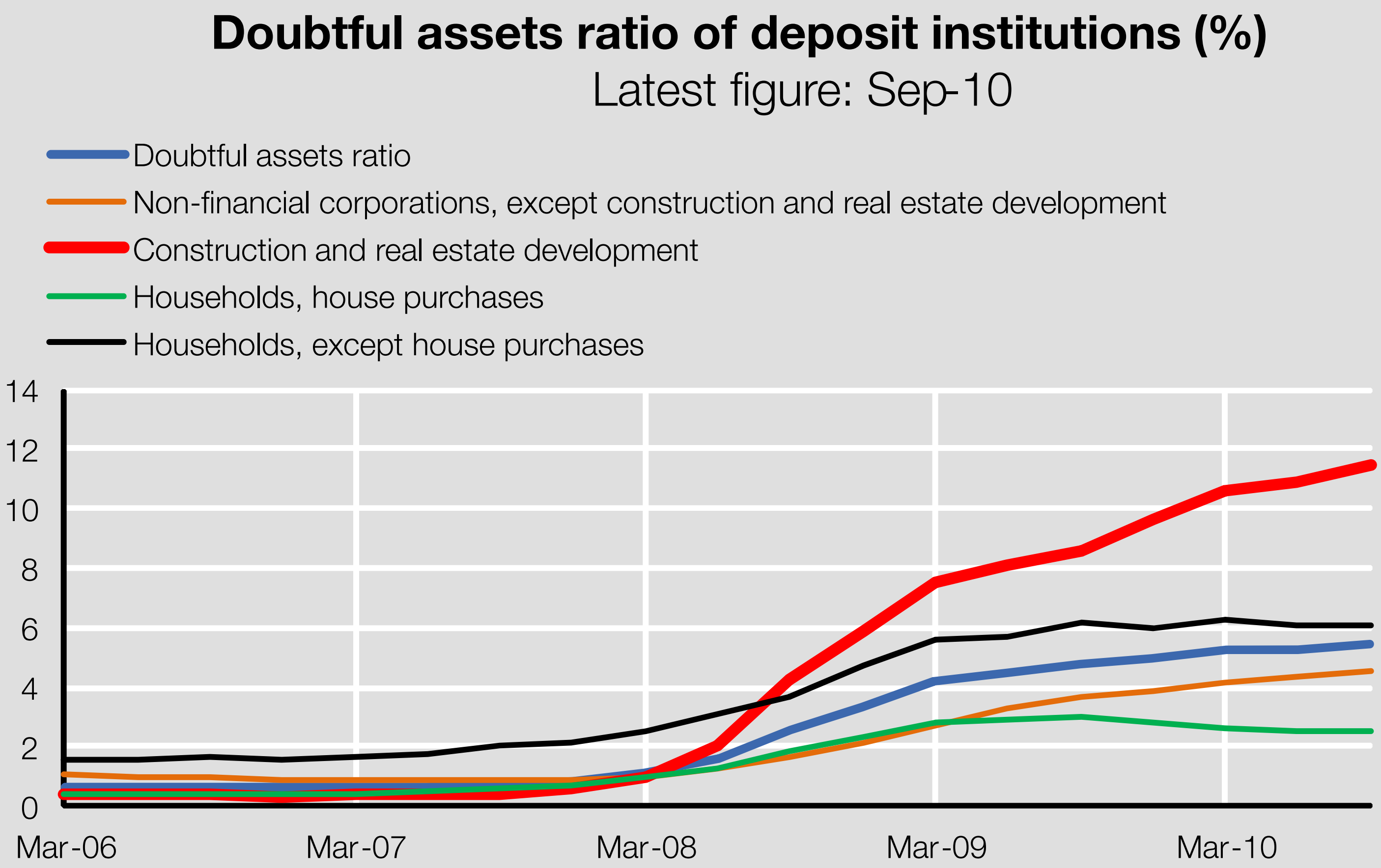
For all these reasons, the significant proportion of total lending accounted for by mortgages – at 39% - is one of the factors of soundness of the Spanish banking system

3. Scale of the real estate problem

SHARE OF CONSTRUCTION AND DEVELOPMENT IN TOTAL LENDING AND TOTAL ASSETS

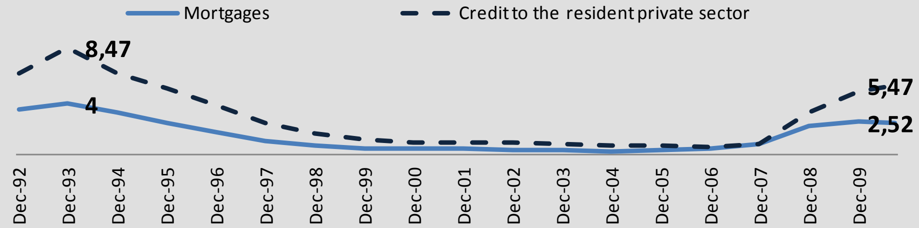


3. Scale of the real estate problem



3. Scale of the real estate problem

Doubtful assets ratio. Deposit institutions, %



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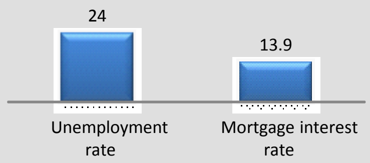
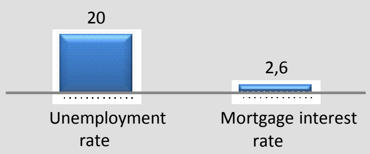
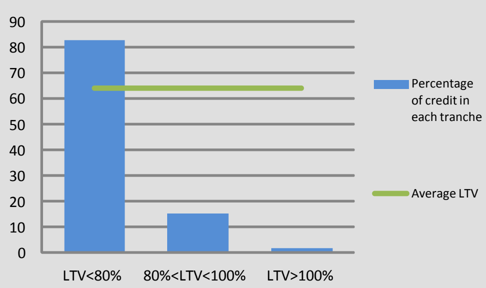


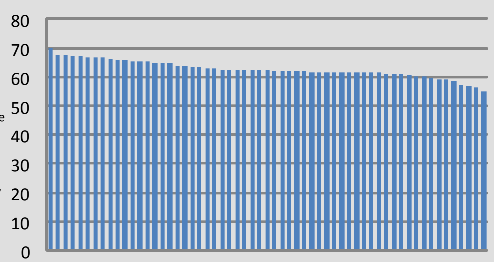
2010



Distribution of mortgage lending based on LTV. Deposit institutions, %



Distribution of average LTV of mortgages, by institution, %



4. The Spanish banking sector during the crisis: restructuring, loan write-downs and capitalisation

Actualizar nombres

- **ADJUSTMENT.** Further to the crisis, **the Spanish banking system has made a sharp adjustment**: restructuring, merger and concentration processes, and reduction in capacity
  - The process designed in the FROB legislation has been completed: from 45 to 17 savings banks

- **LOAN WRITE-DOWNS. Since January 2008, the banking sector has recognised and assumed asset impairment losses for an amount equivalent to nearly 9% of GDP (€52 billion in the case of savings banks; €39 billion in the case of banks)**
  - €53 bn of net specific provisions that lower profit against the P&L accounts
  - Additional €16 bn using the general provision, in force since mid-2000
  - Additional €22 bn of specific provisions against reserves for institutions undergoing restructuring by means of the FROB

- **CAPITALISATION. In addition to recognising losses, banks have reinforced their capital during the crisis, mainly through reserves**
  - The Tier 1 ratio rose from 7.6% at end-2007 to 9.5% in December 2010. This increase in banks' capital is equivalent to 3.7% of GDP
  - The sum of provisions and capital accumulated in the period therefore amounts to around 12.5% of GDP

4. The Spanish banking sector during the crisis: restructuring, loan write-downs and capitalisation

EXTENT OF SAVINGS BANK RESTRUCTURING

Savings banks	Participating institutions	Number of processes	Total assets (30.9.10)
Merger/concentration processes with FROB aid	33	9	886
Merger/concentration processes without FROB aid	7	3	326
Institutions subjected to supervisory intervention*	2	-	
Total restructuring	**40**	**12**	**1.212**
Other	**5**		**74**
Total savings banks**	**45**		**1.286**

* The two savings banks subjected to supervisory intervention are participating in merger/concentration processes

** Not including CECA

4. The Spanish banking sector during the crisis: restructuring, loan write-downs and capitalisation

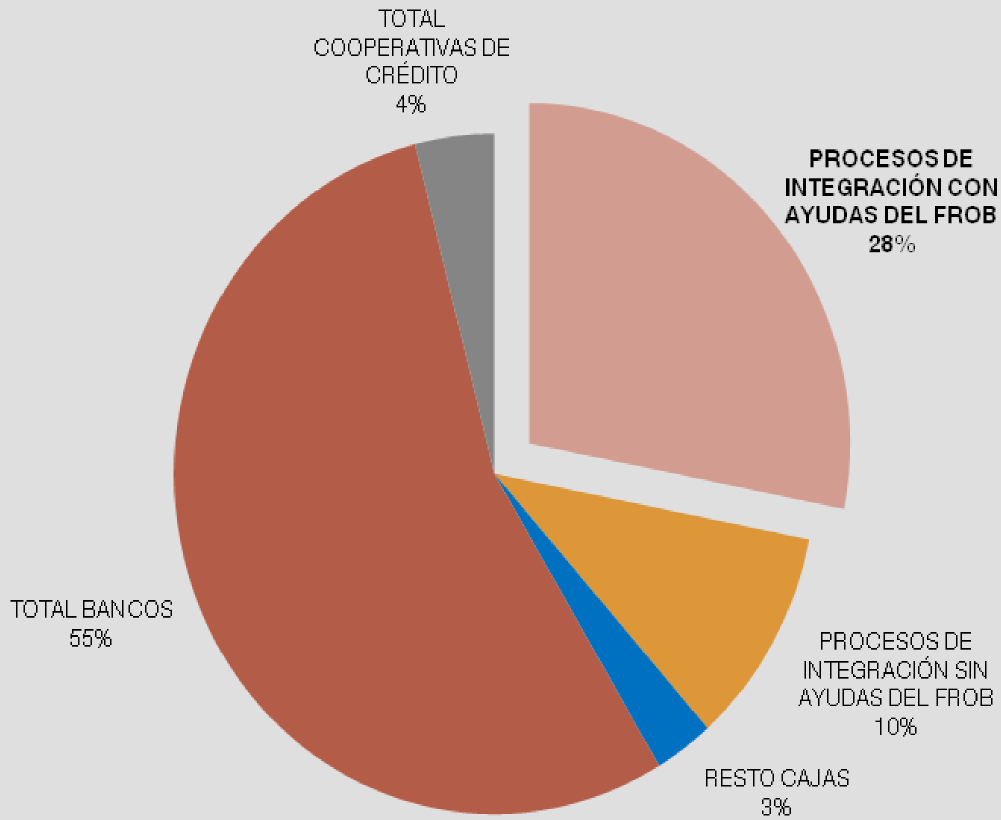
Actualizar nombres

45 savings banks	17 savings banks
Caja Madrid, Bancaja, Laietana, Insular de Canarias, Caja Avila, Caja Segovia, Caja Rioja	Jupiter
La Caixa, Caixa Girona	Caixa
CAM, Cajastur, Caja Cantabria, Caja Extremadura, CCM	Base
Caixa Catalunya, Caixa Manresa, Caixa Tarragona	Catalunya Caixa
Caixa Galicia, Caixanova	Nova Caixa Galicia
Caja Murcia, Caixa Penendés, Sa Nostra, Caja Granada	Mare Nostrum
Caja Duero, Caja España	Espiga
Caja Navarra, Caja Municipal Burgos, Caja Canarias, CajaSol, Caja Guadalajara	Banca Cívica
Caixa Sabadell, Caixa Terrasa, Caixa Manlleu	Unimm
Caja Círculo de Burgos, Caja Badajoz, CAI	Caja3
BBK, CajaSur	BBK
Unicaja, Caja Jaén	Unicaja
Ibercaja	Ibercaja
Kutxa	Kutxa
Caja Vital	Caja Vital
Caja Ontinyent	Caja Ontinyent
Caja Pollença	Caja Pollença

4. The Spanish banking sector during the crisis: restructuring, loan write-downs and capitalisation

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

TOTAL CREDIT COOPERATIVES
MERGER/CONCENTRATION PROCESSES WITH FROB AID
MERGER/CONCENTRATION PROCESSES WITHOUT FROB AID
OTHER SAVINGS BANKS
TOTAL BANKS



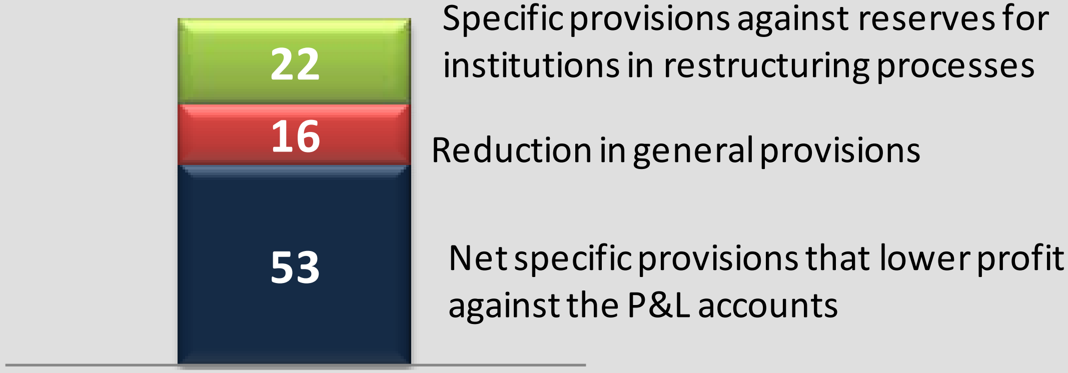
COVERAGE OF POTENTIALLY TROUBLED LOANS IN THE REAL ESTATE DEVELOPMENT AND CONSTRUCTION SECTOR

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

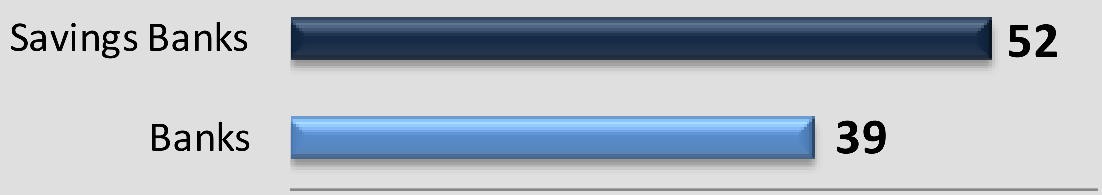
(1) Including €28 bn of doubtul loans, €28 bn of standard loans under surveillance and €44 bn of foreclosures
(2) Including provisions recorded to cover 100% of the incurred loss, plus additional losses recognised as a result of value adjustments in business combinations.

RECOGNITION OF LOSSES

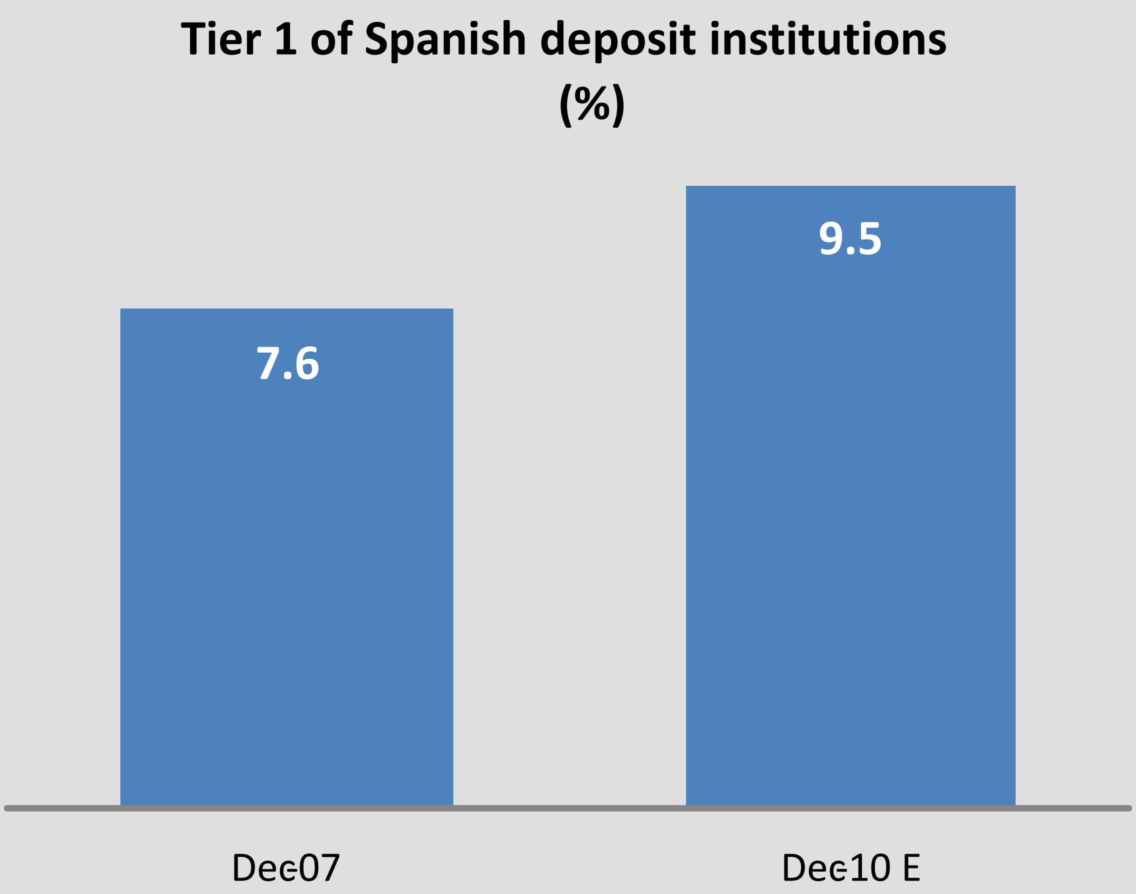
Already consolidated provisions since Jan-08. Deposit institutions, €bn



Already consolidated provisions since Jan-08, €bn



BANKS HAVE STRENGTHENED THEIR CAPITAL



4. The Spanish banking sector during the crisis: restructuring, loan write-downs and capitalisation

AMENDMENT OF THE SAVINGS BANK LAW

-Allows savings banks to issue top-quality capital, facilitating their access to capital markets

- Possibility of issuing equity units with voting rights
- Three alternatives are made available to institutions wishing to go beyond their traditional markets and businesses: i) integration into an IPS co-ordinated by a bank as a central body; ii) assignment of the entire lending and deposit business to a bank; and iii) conversion of the savings bank into a foundation

-Contributes to making their management and governing bodies more professional

-Subjects savings banks to greater market discipline

In short, significant progress has been made during the crisis

- The effects of the first wave of the financial crisis were avoided
- Already-strict valuation criteria were tightened to encourage write-downs in the real estate portfolio
- There has been a major drive to recognise losses (nearly 9% of GDP) and to recapitalise, thanks to banks' fund-generating capacity, but also to the prior existence of general provisions and to the restructuring and merger and concentration processes
- The average size of savings banks has increased and their number has been cut significantly (from 45 to 17), which contributes to correcting the excessive size of the sector, to generating gains in efficiency and to improving their capacity to obtain funding
- The legal framework for savings banks has been amended (possibility of raising top-quality capital, greater incentives for good management)

5. Transparency

JULY 2010 STRESS TESTS

The stress tests were very transparent …

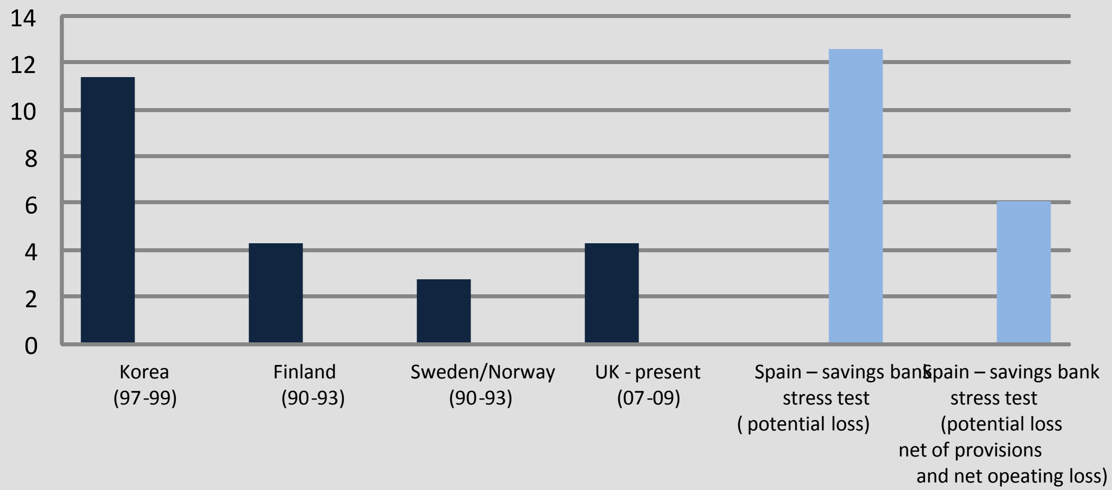
- All listed banks and all savings banks were tested (around 90% of the Spanish banking sector's total assets)
- In addition to publishing bank-by-bank data using the common Europe-wide format defined, highly detailed information was published for each bank

… and demanding in terms of the parameters used

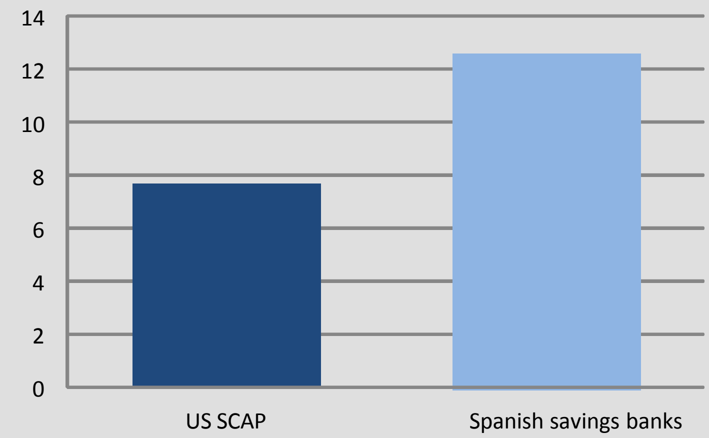
- 2.6% fall in GDP in the period analysed (on top of 3.6% in 2009)
- Highly significant reductions in collateral values
  - *28% for finished housing*
  - *50% for houses under development*
  - *62% for land*
  - *Price falls in reality have been lower than those considered in the stress tests*
- For savings banks, the exercise assumed net operating income before provisions that was 37% lower than the average over the past 20 years
  - In the US stress tests, the profit margin was 15% less than the average margin for the past 20 years

REQUIREMENTS OF THE STRESS TEST CONDUCTED IN SPAIN

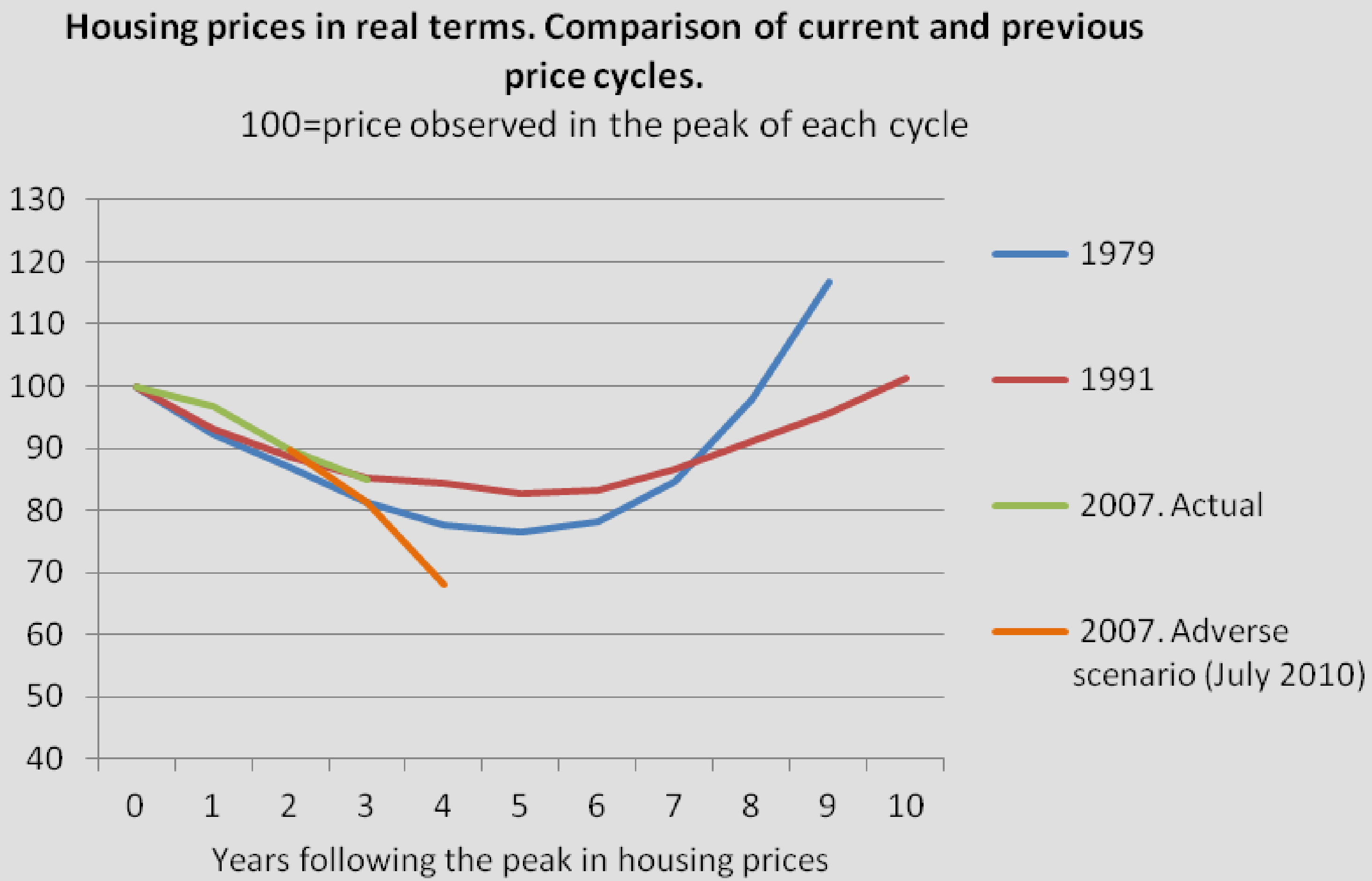
Loss as a percentage of risk-weighted assets, %



Potential loss / risk-weighted assets, %



5. Transparency



ADDITIONAL TRANSPARENCY REQUIREMENTS FOLLOWING THE IRISH CRISIS

-Given the doubts raised in recent months, the Banco de España has called on banks to publish full details of lending to the real estate development and construction sector

- Publication was exceptionally brought forward for savings banks to January
- All banks will have to publish the information in their annual accounts, which will require verification by external auditors

-The information already published by Spanish savings banks is highly detailed, in particular regarding their real estate development and construction portfolio

EXPOSURE OF SAVINGS BANKS TO THE REAL ESTATE DEVELOPMENT AND CONSTRUCTION SECTOR

	Exposure	% of exposure	% of total credit risk (2)
Credit risk (1)	**173**	**80%**	**18%**
	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 loans 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 loans	28	13%	3%
Completed development	*9*	*4%*	*1%*
Development in progress	*5*	*2%*	*1%*
Urban and developable land	*7*	*3%*	*1%*
Other	*7*	*3%*	*1%*
Foreclosed real estate	**44**	**20%**	**4%**
Completed housing	*18*	*8%*	*2%*
Houses 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.

6. Royal Decree-Law 2/2011

FUNDAMENTAL OBJECTIVES

- The degree of banks' capitalisation is raised to improve their access to funding and, generally, to strengthen confidence in the soundness of the Spanish banking system

- Banks are encouraged to tap the capital markets and to adopt structures that the markets can readily understand and assess

- Restructuring is accelerated in accordance with Community competition rules

- As from the enactment of the Royal Decree-Law, Spanish banks will be operating with a core capital ratio of at least 8% (10% in the case of those with greater dependence on wholesale markets and which have not shown ability to tap the capital markets)

NEW CAPITAL REQUIREMENTS

- A core capital ratio of at least 8% is required of banks

  - This draws closer to the Basel III-2013 core capital definition…
  - …tightening most significantly the minimum requirement
  - Such tightening is not subject to value judgment: it will depend on (1) starting position and (2) minimum capital requirement

- The required core capital ratio will be 10% for credit institutions evidencing the following two conditions:

  - They have a wholesale funding ratio of over 20%
  - An amount equal to or greater than 20% of their share capital or voting equity has not been placed with third parties

- The FROB acts as a backstop as from the approval of the Royal Decree-Law

  - Banks that cannot raise capital on the market will resort to the FROB
  - To all intents and purposes this means that, further to the enactment of the Royal Decree-Law, Spanish banks will operate with a core capital ratio of at least 8%

6. Royal Decree-Law 2/2011

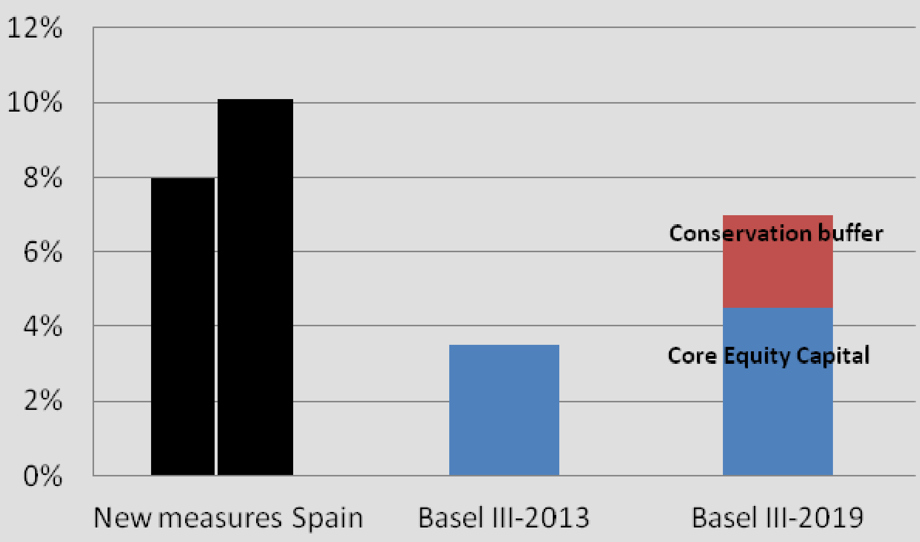
Definition of core capital: new measures approved

+ Paid-up capital
+ Reserves
+ Share premium
+ Positive results for the year (% foreseeable devoted to reserves)
+ Unrealised gains on fixed income and equity in the available-for-sale financial assets portfolio
+ Minority interests
+ Subordinated debt compulsory convertible into common shares (*)
+ FROB support

- Own shares
- Losses for the year
- Goodwill
- Other intangible assets
- Unrealised losses on fixed income and equity in the available-for-sale financial assets portfolio
- Other net balances of other comprehensive income

(*) Compulsory conversion into shares at the latest by 31st December 2014; pre-fixed conversion equation; subject to issuer discretion regarding coupon payment when its solvency situation requires it; and admissible as own funds for accounting purposes

Core capital requirements under the new Spanish regulations compared with what Basel III-2013 will demand



6. Royal Decree-Law 2/2011

The new measures will have Spanish credit institutions operating with very high core capital levels

- **The core capital definition draws closer to the Basel III-2013 definition of core capital, but raising capital requirements above the figure stipulated under Basel III (which in 2013 is 3.5%)**

- **Further, this strengthening of solvency comes about after**

  – ***Banks have recognised asset impairment losses equivalent to nearly 9% of GDP and have increased their capital, in particular top-quality capital***

  – ***They have recapitalised under the*** *savings bank merger and concentration processes that have applied to the* ***FROB, for an amount of €11.6 bn***

  – ***Provisioning rules have been tightened,*** *in particular concerning collateral valuations (applying severe haircuts) and those that have to be set aside for foreclosures*

  –***Total transparency has been required of banks*** *regarding their exposure to the real estate development and construction sector, reinforcing what was already done in the July 2010*

CONSEQUENCES OF THE ROYAL DECREE-LAW

- In allowing levels below that of 10% (i.e. 8%) generally required of credit institutions, they are encouraged to tap the capital markets to a greater extent
- It facilitates access to the market, offering greater guarantees to investors in fixed-income and equity
- It encourages professional management via greater market discipline
- It maintains the “brand value” of savings banks, which is particularly strong in their regions of origin
- It allows favourable characteristics of the savings bank model to be retained:
  - **Proximity to local markets**
  - **Focus on the business of SMEs and individuals**
  - **Profits returned back into society**

The legal structure of business does not determine business strategy, but it may provide for more professional management, better understanding by the markets and greater accessibility to the markets.

7. Implementation of the Royal Decree-Law. Next steps

FOLLOWING APPROVAL OF THE ROYAL DECREE-LAW, THE NEXT STEPS ARE:

- **From its entry into force:**
  - Insofar as the FROB acts as a backstop, Spanish credit institutions will be operating with a core capital ratio of 8%-10%
- **In March:**
  - Banks will be advised in early March as to whether they meet the new capital requirements established in the Royal Decree-Law, or whether they need additional capital to reach the minimum levels of 8% or 10%, as appropriate
  - Those banks that do not see increasing their capital on the market as viable will resort immediately to the FROB
  - Those others that do consider it feasible will, following approval by the Banco de España, have until September to comply. That said, they will be asked to submit a plan considering alternatives (including FROB support), should they not meet their objectives on the market
- **In September:**
  - Where necessary, the FROB will provide the funds for the difference between the capital needed to comply with the Royal Decree-Law and what banks may have been able to raise on the market
  - If a bank should fail to comply with the timetable due to sufficiently warranted reasons concerning the processing of formalities, the Banco de España shall extend the deadline by up to three months (December 2011). In cases of market listing, the deadline may exceptionally be extended to the first quarter of 2012

7. Implementation of the Royal Decree-Law: next steps

FOR THOSE BANKS HAVING TO RESORT TO THE FROB:

- The **FROB** will acquire **ordinary shares**
- If a **savings bank** were in this situation, this would mean that it would **have to transfer its activity to a bank**
- The **FROB would sit as a special director on the governing body of the bank issuing shares**
- The bank must submit a **recapitalisation plan that has to be approved by the Banco de España,** and it must **include a business plan** with efficiency, profitability, leverage and liquidity targets
  - ***Measures aimed at improving their efficiency, rationalising their administration and management, and re-scaling their productive capacity shall be stipulated in order to improve their future outlook***
- The FROB will sell the securities it has acquired within a period not exceeding five years as from the date of their subscription