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The Royal Decree-Law enacted by the government strengthens financial system solvency and will enable sector restructuring to be completed

The Royal Decree-Law enacted on Friday by the government will further strengthen the solvency of the Spanish financial system and enable completion of the sector restructuring initiated following the outbreak of the financial crisis three-and-a-half years ago. The new legislation ensures that banks will have appropriate ways to obtain the (private or public) capital they need, once they have made all disclosures on their actual situation and their risks in accordance with the highest standards of transparency and have addressed the write-down of their most problematic assets.

The purpose of the new measures is to dispel the doubts and uncertainties over the health of Spain's financial system and to restore market confidence, which was particularly dented by the second wave of the sovereign debt crisis last November. That crisis centred on Ireland but had a contagion effect on other euro area economies. The Banco de España considers that the worsening of funding difficulties on the international markets due to heightened misgivings made it imperative to adopt more measures to accelerate and complete the progress already made in the restructuring of the Spanish banking system.

With the Royal Decree-Law in force, the Banco de España will now assess how much capital each bank will need to reach the required level of solvency (8% of total risk-weighted assets, but it can be increased to 10% for banks that fail to meet certain requirements set in the Royal Decree-Law). In early March the Banco de España will set out the capital needed by each bank. The banks that fail to reach that level will have to draw up a recapitalisation plan to reach it. If they cannot obtain the required capital from private investors in the specified period, they will, from the outset, have funds available from the FROB, which may take a stake in their capital for a limited time (five years maximum).

These new measures approved by the government are intended to complete the so far encouraging process of restructuring. The last few months have seen not only the largest banking concentration in Spain (45 savings banks have given way to 17 banks or groups, and there have been other concentration processes at banks and rural credit cooperatives), but also substantial balance sheet write-downs, much higher transparency through detailed disclosures on real estate exposures and wholesale funding, and improved efficiency due to cuts in excess capacity. Moreover, the reform of the Savings Banks Law, whose passage through Parliament met broad consensus across the political spectrum, resolved the problem which was preventing savings banks from obtaining high-quality capital and improving their corporate governance.

The process of restructuring and balance sheet write-downs undertaken by savings banks to redress the imbalances built up during the boom years was necessary to restore confidence in the markets, which routinely pointed to two main weaknesses: excessive exposure to the real estate development and construction sector, and dependence on wholesale funding. In both these respects, banks have made an extraordinary transparency drive, furnishing highly detailed figures on their individual situation in the last few weeks.

On December 2010 figures, the total exposure of savings banks to the real estate development and construction sector amounted to €217 billion, of which €173 billion were loans (18% of total lending by savings banks) and €44 billion were real estate assets foreclosed or received in payment of debt. Of that figure, the potentially troubled banking book (that classified as doubtful, sub-standard and foreclosed) amounted to €100 billion.

In addition to the transparency drive, assets have been written down considerably through application of the accounting rules approved by the Banco de España. In this way, the Banco de España has ensured that banks now enjoy a very considerable coverage of their risk exposure through provisions and have been very prudent in accounting for their exposures to the real estate development and construction sector. Specifically, they have recognised as potentially troubled an extremely high percentage (46%) of their exposures in this sector and one hundred percent of the losses incurred in this portfolio are now covered by provisions. Furthermore, the provisions also cover additional losses recorded in mergers as a result of application of fair value accounting.

As regards paring back the excess capacity which resulted from the rapid network growth during the economic upturn, it should be noted that savings banks' merger and concentration plans envisage significant cuts in branch numbers (between 10% and 25%) and in staff (between 12% and 18%). Banks are briskly implementing these plans, which are allowing them to improve their efficiency.