The Spanish Banking Sector

London 19th April
Singapore 23rd April
Hong Kong 24th April
Tokyo 25th April

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The Spanish economy has accumulated significant interrelated imbalances during its expansionary phase.

- Current account deficit
- Excessive growth of the real estate sector
- Indebtedness of the private sector

The current international macroeconomic and financial crisis, together with the Spanish economy’s process of adjustment, is resulting in a

- Strong increase in unemployment
- Rapid increase in the public debt
The adjustment of previously accumulated imbalances, in an adverse international context, results in a negative evolution of the Spanish economy and strong job destruction.

![Unemployment rate graph]

Sources: INE, IMF Projections
- **Spain’s budget deficit has worsened**, significantly increasing the debt-to-GDP ratio. The later is still below that observed in other European countries.

**Budget deficit as % of GDP**

**Public debt as % of GDP. Year 2011**

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>120</td>
</tr>
<tr>
<td>France</td>
<td>80</td>
</tr>
<tr>
<td>UK</td>
<td>80</td>
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<tr>
<td>Germany</td>
<td>80</td>
</tr>
<tr>
<td>Spain</td>
<td>60</td>
</tr>
</tbody>
</table>

Sources: IMF and Eurostat
In order to assess the need for adjustment of the economy it is also important to take into account some considerations.

- The strong increase in the Spanish current account deficit since the start of the Monetary Union was not caused by export underperformance.
- Current account deficit is now under a process of correction, but external debt is still high.

### Export market shares of goods in real terms, %

- **SPAIN**
- **FRANCE**
- **GERMANY**
- **ITALY**
- **UK**

### Spanish current account deficit as % of GDP

Sources: IMF and Eurostat

Sources: IMF, INE and Eurostat. IMF Projections
Gross saving did not undergo a significant reduction. In fact, Spanish economic growth was accompanied by high levels of investment ...

Sources: IMF and Eurostat

Total investment as % of GDP

Gross savings as % of GDP

Sources: IMF, INE and Eurostat
THE SPANISH ECONOMY IN PERSPECTIVE

- A portion of these high levels of investment was in residential investment.

- In any case, the Spanish economy witnessed an excessive increase in the housing sector during the expansionary phase.

- This imbalance is under adjustment, and is thus exerting a negative impact on the Spanish GDP growth rate.

Sources: IMF, INE and Eurostat.
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The Government approved in February a comprehensive reform of the labour market: it is geared to increasing companies’ flexibility so they may adapt to negative macroeconomic shocks without reducing employment.

Two key areas of reform …

- Promotion of the decentralisation of collective bargaining and facilitating opt-out clauses in order to give companies more internal flexibility to set wages.

- Cutting dismissal costs, reducing the degree of protection of permanent-contract workers.

... giving greater flexibility to companies to react to the situation of the economy.
This labour market reform comes on top of the wage agreement signed by social agents on January 25th for the period 2012 – 2014 which

- sets ambitious targets for wage moderation for the private sector,
- weakens the potential impact of indexation clauses,
- and recommends the use of variable wage components linked to firm-specific variables.
In the fiscal domain the Government has submitted to Parliament a draft Organic Law.

This law implements the constitutional reform of the national fiscal framework approved last year in order to set limits on the public debt and deficit, including the balance budget concept in the Constitution. This already includes the main features of the so-called Fiscal Compact signed by the European Union Member States.

The law includes stricter information requirements and new coercive mechanisms to guarantee compliance with new fiscal target at all levels of government.

- The Central Government may initiate all the necessary actions against the Regional Government that fail to comply with the agreed fiscal targets.

Severe personal sanctions for those public sector managers that do not comply with the national fiscal framework.

The Government approved on 30th March the Budget for the year 2012, which targets a reduction of the fiscal deficit of 3.2 percentage points this year.
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During 2011 and to date, the restructuring of the Spanish banking sector has been under way, reducing the number of institutions, the capacity in the sector and transforming savings banks into commercial banks, ...

- The number of savings banks has been significantly reduced (28 had disappeared up to December, and the process continues) ...

- ... and all these institutions have transferred their activity to commercial banks

- The reduction in capacity is observable in the reduction in the number of branches and employees from their peak in mid-2008

1With the exception of the two smallest ones, which are very small and operate in their local regional market
... has significantly increased the capital of the highest quality ...

- RDL 2/2011, approved in February 2011, ensures that all Spanish institutions are operating with core capital requirements of 8%

- The EBA recapitalisation programme - for major European banks - involves raising Core Tier1 capital to 9% and the valuation at market prices of general government debt instruments. The deadline is end-June 2012.

  - Five Spanish deposit institutions have to increase their core capital by an amount of €26bn. At this point in time Spanish institutions have basically complied with these new requirements
...increasing the recognition of asset impairment losses through provisioning requirements ...

- Since June 2008 and thus not taking into account the new measures approved by the Spanish Government regarding construction and property development-related assets (see next slide), provisions have been increased by €112bn

- ...and requiring Spanish deposit institutions to disclose all relevant information regarding their exposures to construction and property developers
In February 2012, the Spanish Government approved new measures for the Spanish banking sector (RDL 2/2012)

The reason was the uncertainty still prevailing regarding the value of construction and property development-related assets on banks’ balance sheets, in a context of increasing macroeconomic and financial tensions in the euro area.
The objective was to eliminate this uncertainty.

1. Problematic assets were recognised reaching very demanding level: by June 54% of the construction and property development portfolio was classified as problematic. In addition, the RDL 2/2012 requires general provisions (7% of the normal portfolio) to take into account potential migration from the normal to the problematic portfolio.

2. RDL 2/2012 requires higher levels of provisions and capital in order to ensure the clean-up of bank balance sheets: an additional amount of €53.8bn.

- On April 17th the Executive Commission of the Banco de España approved the plans that institutions submitted prior to 31 March for complying with the RDL 2/2012. The results in terms of provisioning needs are +€29.08 billion in addition to the extraordinary write-downs of €9.19 billion made in advance at the close of 2011. Core capital requirements amounts +15.58 billion. Thus, the total additional amount resulting from the RDL 2/2012 is €53.8bn.
These higher levels of specific provisions and capital add-ons entail increasing the levels of coverage of the problematic portfolio.
These levels of coverage, together with the loan-to-value ratios of the portfolio, mean that bank balance sheets are on average protected against decreases in the value of land of 87% (82% for housing under development).
The sector is undergoing a necessary process of adjustment, which is still compatible with an active housing market.
THE SPANISH BANKING SECTOR

- Despite this adjustment in the real estate market in Spain, the non-performing loan ratio of the retail mortgage portfolio is still low.

- The retail mortgage business in Spain is plain-vanilla (no buy-to-let, no home equity lines of credit, ...) and regulation introduces strong incentives for clients to meet their financial obligations (recourse mortgages).

- ... and the average loan-to-value ratio of the portfolio is relatively low, standing at average levels for the sector of 62%.
The doubtful loan ratio of credit to non-financial companies excluding construction and property developers is lower than the doubtful loan ratio of total credit.

Except for the biggest non-financial companies, the doubtful loan ratio is similar for the different size classes.

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1 Corporation size is proxied by the volume of bank debt reported to the Banco de España Central Credit Register (CIRBE)
• In a challenging macroeconomic environment, additional increases in the doubtful loans ratio are expected.

![Graph](image-url)
Against a background of uncertainty and volatility in the financial markets, Spanish financial institutions have used the possibilities offered by the ECB’s two 3-year LTROs

- Increasing the funds obtained …
- … and replacing previous shorter-term ECB funding

In December 2011 the ECB approved that National Central Banks may accept as collateral for Eurosystem credit operations still-performing credit claims that meet specific eligibility criteria. In the Spanish case, this new temporary framework was defined in February 2012. The use of this type of collateral by Spanish deposit institutions has been very limited, up to 0.3%
THE SPANISH BANKING SECTOR

- With the funds obtained from the ECB’s 3-year LTROs, **the wholesale funding maturities for year 2012 for Spanish banking institutions are already covered**

- On top of that, Spanish banking institutions are still making good use of windows of opportunity in the wholesale markets, as has been the case in the opening months of 2012

- There is a risk that banking institutions simply rely on the ECB 3-year LTROs: this is not the case for Spanish banking institutions as, simultaneously, they have been required to increase their capital and provisions
On the retail funding side, deposits from non-financial corporations and households are experiencing negative year-on-year rates of change.

To appropriately assess this recent trend in deposits, it is relevant to consider that it is affected by some short-term current developments.

- Higher competition with other banking products, and in particular commercial paper distributed to retail clients. Considering the impact of this element on the recent evolution of deposits, it would be basically flat.

- Nevertheless, the recent decrease in deposits could also be partly explained by higher competition with non-banking saving products (i.e. Spanish Treasury Bills).

- and there has also been an observable increase in investment in deposits in the rest of the world, especially by companies –foreseeably multinationals-, that would explained around a 15% of the decrease.
THE SPANISH BANKING SECTOR

- The P&L of the Spanish banking sector is under pressure mainly to
  - Narrower margins in a context of lower activity and tensions in the funding markets
  - Higher provisioning requirements, particularly this year due to the application of RDL 2/2012 measures

- On the positive side it is relevant to consider
  - Margins on new operations are performing better, and this is having an impact on the average spreads
  - Provisioning requirements resulting from the new measures are a one-off
  - The Spanish banks do not have a problem in terms of their business model
  - Efforts in the reduction of capacity will be a positive in the medium term

(*) The assets-weighted marginal rates include, inter alia, those applied to housing and consumer finance and credit to non-financial corporations, while the liabilities-weighted ones include, inter alia, fixed-term deposits and repos
On top of all the measures and developments mentioned in previous slides, it is also important to factor in the assessment of the Spanish banking sector the **structural measures** adopted regarding the Spanish banking sector.

- **Transformation of savings banks into commercial banks**: there are no savings banks pursuing financial activity left in Spain (*)

- **Significant reduction in the number of former savings banks** (from 45 before the crisis to 11 institutions considering the ongoing already announced processes)

- **Rapid crisis resolution scheme**: the FROB has been able to initiate rapidly the process of disposal of intervened institutions, and thus the creation of a big and inefficient public bank/banking sector has been avoided

(*) Except the two smallest ones, that are very small and very located in their local region
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To finalise the ongoing disposal of FROB holdings of the capital of the five banking institutions in which it has a majority

- The disposal of the holdings of the FROB through competitive processes has already been carried out for two institutions.

- On 12th April 2012 the FROB resolved to initiate the process of disposal of its holding in one institution through a competitive process. It has also approved the initial plan for the restructuring of another institution and contacts have been made in order to design its competitive sale.

  - Both procedures will be pursued as speedily as possible and, in any event, will be concluded before the summer.
CONCLUSION – WHAT’S NEXT?

- To finalise the implementation of the measures of RDL 2/2012

  - On 31\textsuperscript{st} March 2012, Spanish banking institutions submitted to the BdE a plan to comply with the measures. On April 17\textsuperscript{th} the Executive Commission of the BdE approved credit institutions’ plans to comply with the RDL (additional provisions and core capital amounts for €53.8bn)

  - Those institutions that are planning to enter into merger processes need to submit their plans before 31\textsuperscript{st} May 2012 for the approval of the Ministry of Economy

  - Institutions have to comply with the new measures of RDL 2/2012 before year-end 2012. Institutions that are in merger processes have 12 months to comply with RDL 2/2012 after the approval of the integration plan by the Ministry of Economy
CONCLUSION – WHAT’S NEXT?

- **Further consolidation of the sector and reduction in capacity**
  - In addition to the incentives given by the new regulatory framework, market dynamics will also put pressure on the banking sector to reduce capacity.

- **Separate the legacy assets from the rest of the banking business?**
  - After recognition of problematic assets (54%) and valuation adjustments (provisioning requirements reaching a coverage ratio of 80% for land related assets and 65% for housing under development), a third step would be ringfencing.

  - Increases clarity with respect to external stakeholders.

  - and internally allows for a better alignment of managers’ incentives to concentrate their efforts on the going-concern part of the balance sheet.
THANK YOU
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**Doubt 1: Public debt to GDP is much higher than the official figures, reaching a level of around 90%**

- **General Government Debt as a % of GDP**, under the definitions and methodology of the Excessive Deficit Procedure, is **68.5% in 2011 and not 90%**

- Other definitions are possible, but in order to make figures comparable across countries, alternative definitions should be applied to all of them

- Moreover, in many occasions, the computation of these other figures using other definitions is wrong
Doubt 2: There is a huge amount of unpaid bills to public sector suppliers that will impact Spanish debt-to-GDP ratio

- This would be reflected in the amount of Other Accounts Payable

- Under the definitions and methodology of the Excessive Deficit Procedure they are not included in the General Government Debt for any Euro Area country

- In Spain, considering this item, the debt to GDP ratio would increase from 68.5% to 73%

- In order to make cross-country comparisons, this calculation should also be made for other countries where Other Accounts Payable could be relevant

Sources: Eurostat
Doubt 3: Public deficit deviation responds to occultation of the reality and/or manipulation of the figures

- This is simply false

- What’s more, most of the deviation from the original target (6%) to the observed data (8.5%) is explained by lower revenues (almost 90% of the deviation) in the context of a weaker macroeconomic outlook and not by an increase in expenses
**Doubt 4: The Spanish economy has no growth capacity**

- The Spanish economy is undergoing an adjustment process, largely in connection with the construction sector.

- There has been a downward revision of GDP growth projections for the major euro area countries.
**DOUBTS AND MYTHS ABOUT THE MACRO-FINANCIAL SITUATION IN SPAIN**

*Doubt 5: It is impossible to generate growth in a context of deleveraging*

- The argument is not so simple: how deleverage impacts economic growth depends very much on the deleveraging process itself

- In Spain, this means redirecting resources from financing real estate assets more to export-oriented sectors and employment creating SMEs

- And even the de-leveraging in the sectors where it is needed should be done in an orderly fashion in terms of timing
Doubt 6: *The level of coverage for the real estate portfolio of Spanish banks is not enough*

- Banks balance sheets are on average significantly protected against decreases in the value of real estate assets