BANCO DE ESPAÑA
Eurosistema

Spanish Banking Sector: Progress Report

22/02/2011

London – 22nd February 2011

Tokyo – 25th February 2011

Hong Kong – 28th February 2011

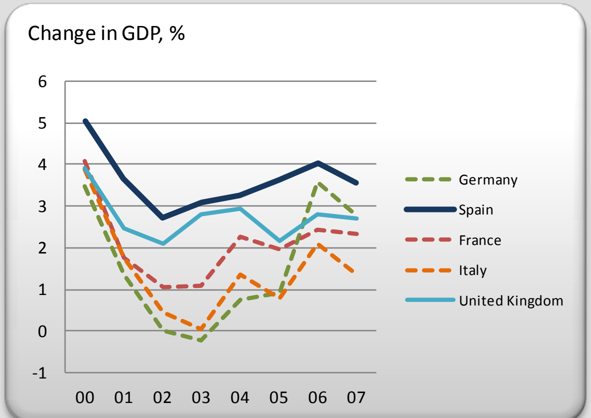
Singapore – 1st March 2011

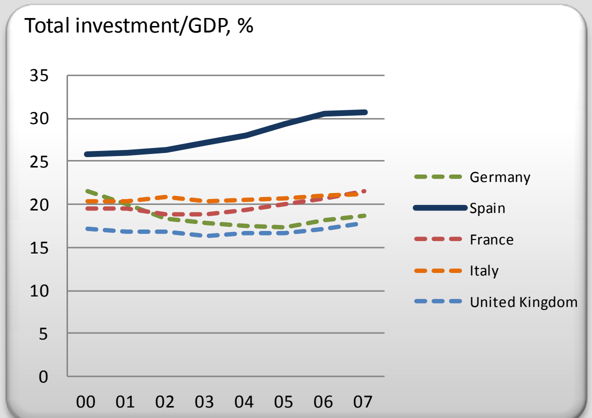
José María Roldán
Director General of Banking Regulation
Banco de España

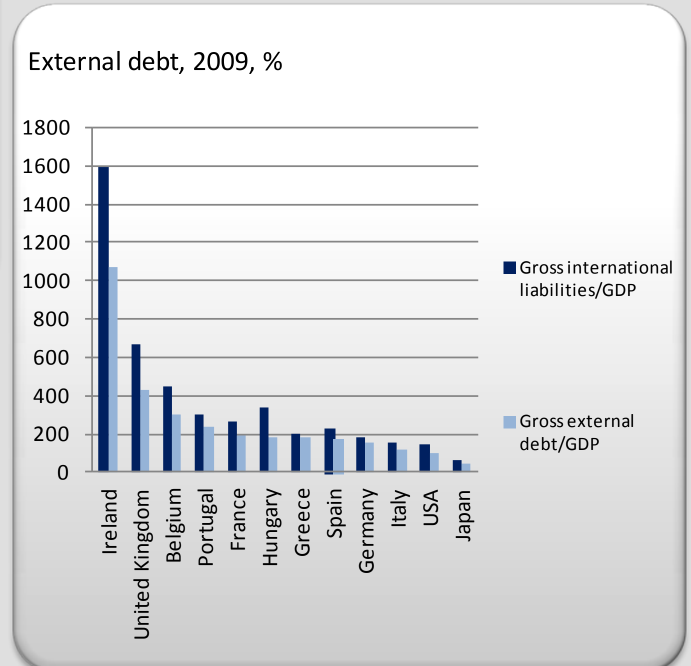
CONTENTS

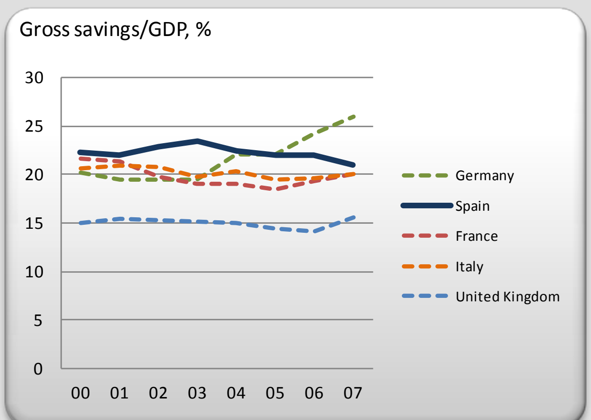
The Spanish economy in perspective

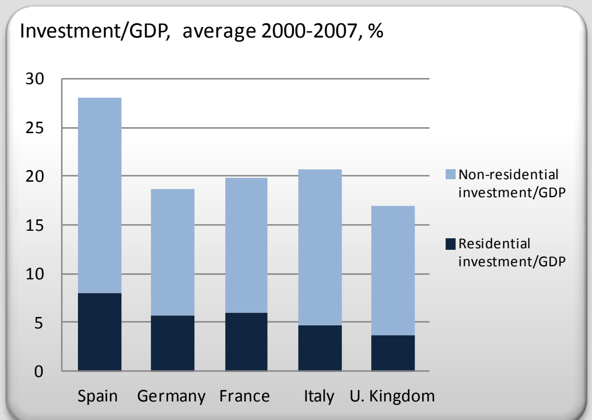
- **The Spanish economy's sharp growth was accompanied by high levels of investment, only partly residential investment**







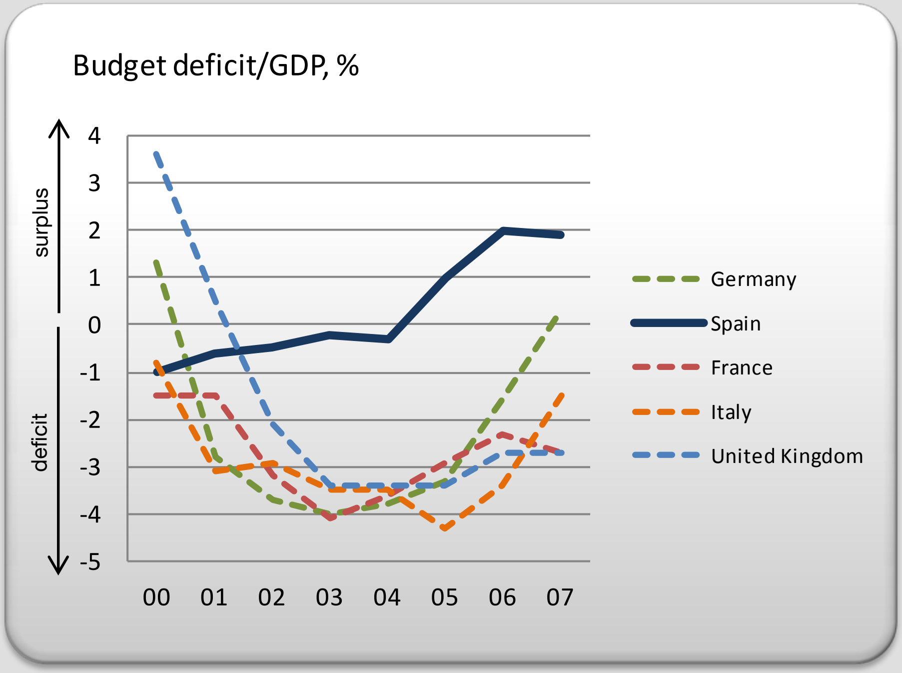


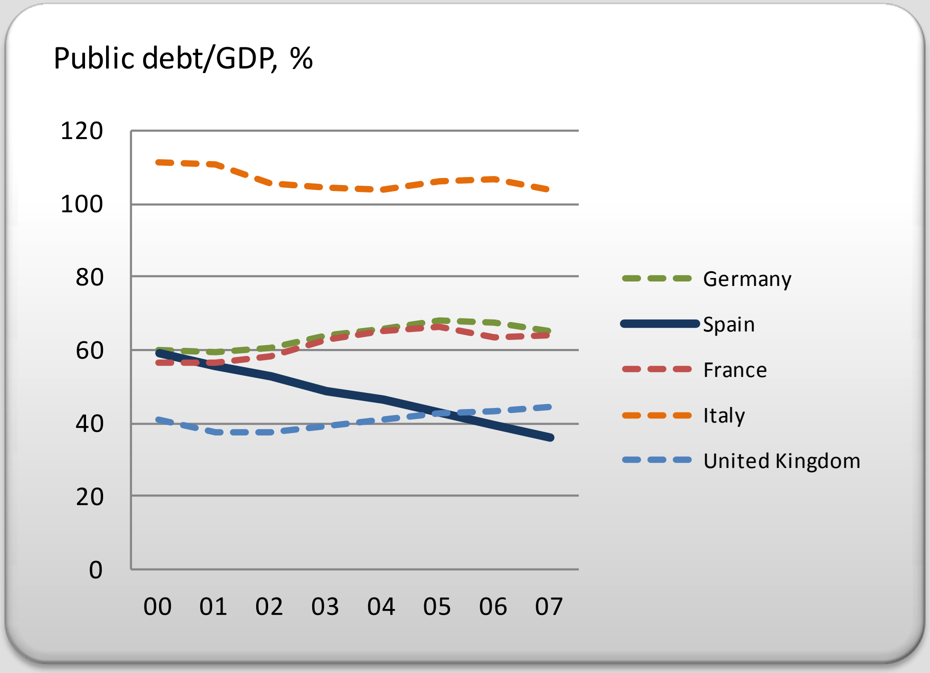


SOURCES: ECB, Eurostat and Citigroup

The Spanish economy in perspective

- The growth process was accompanied by **budgetary equilibrium and lower, and declining, levels of public debt, unlike** in **other EU countries**





SOURCE: Eurostat

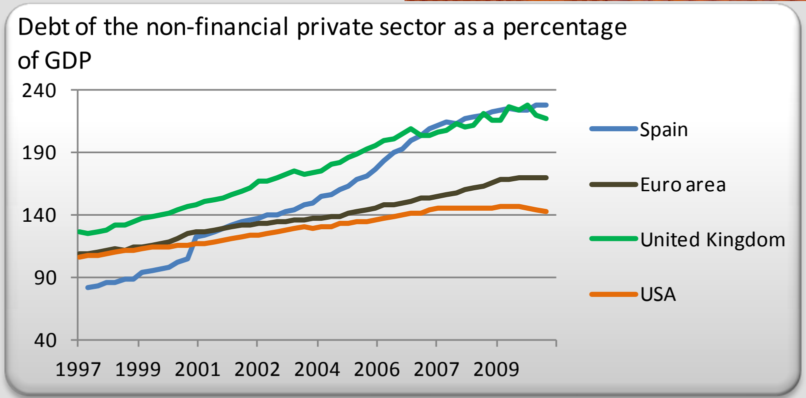
The Spanish economy in perspective

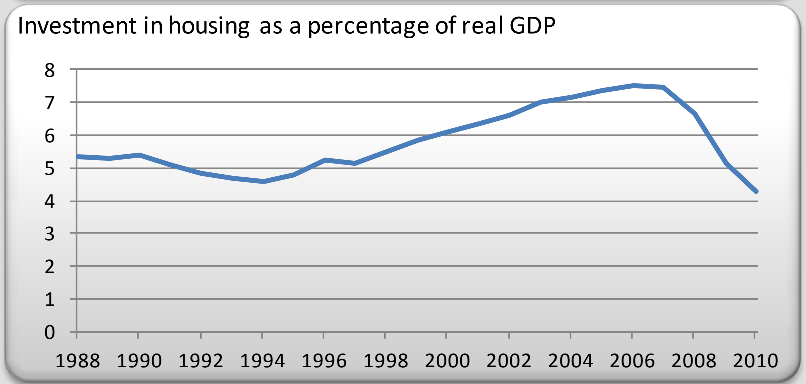
- But some **imbalances were also built up** in the Spanish economy **during its expansionary phase**

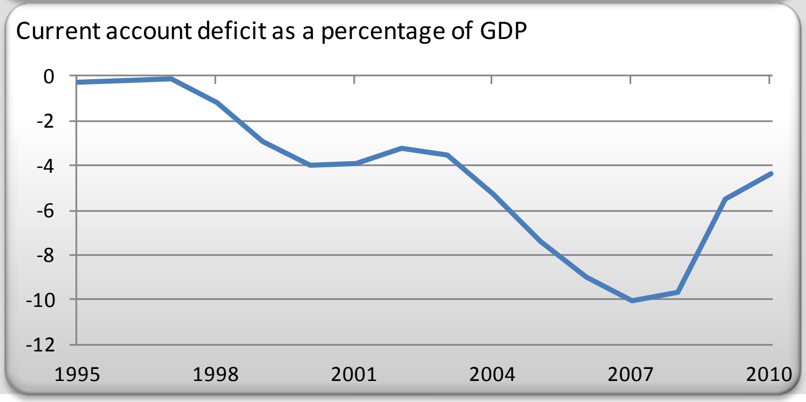
  - Increasing **indebtedness** of the private sector

  - Excessive increase of the **housing sector**

  - Increasing **current account deficit**





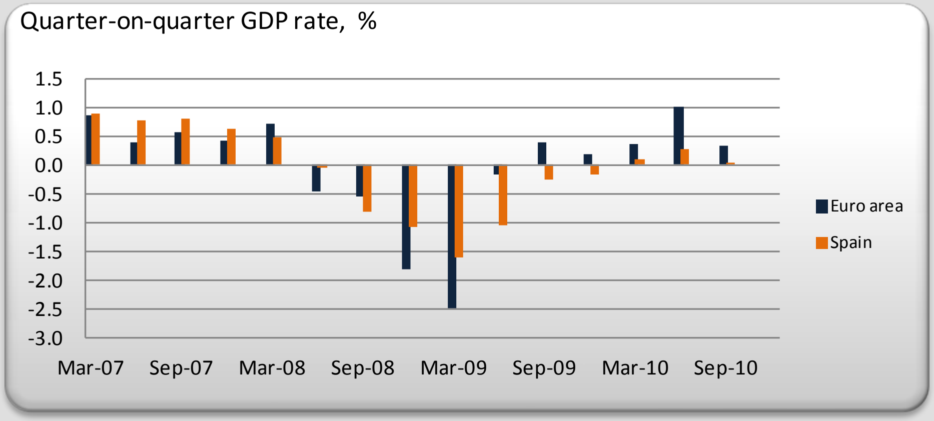


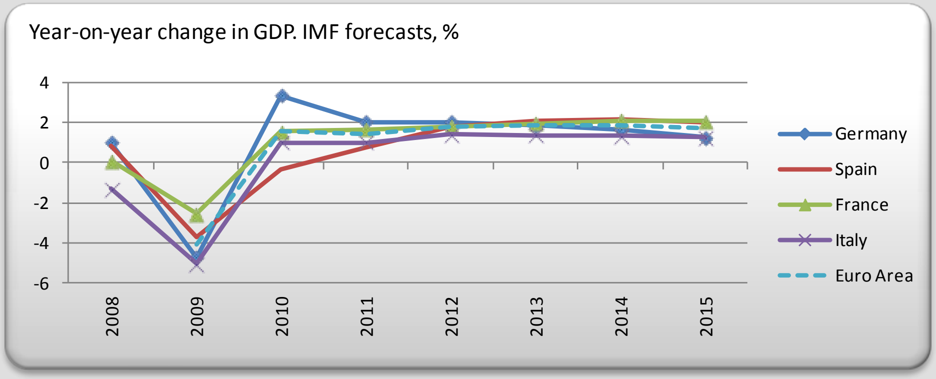
SOURCE: ECB, Federal Reserve and Office of National Statistics

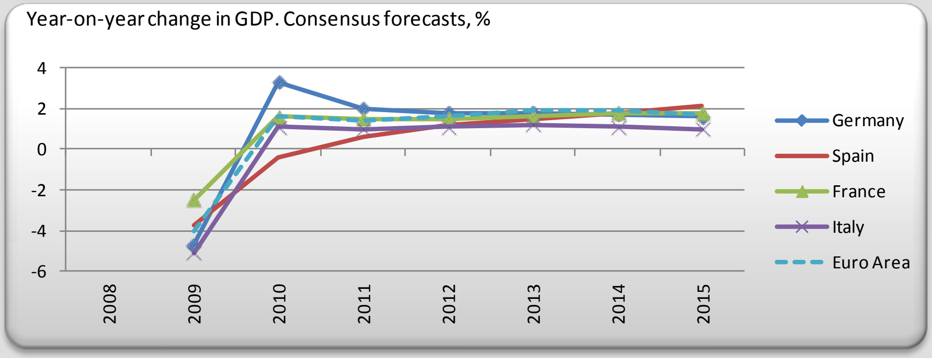
The Spanish economy in perspective

- **Currently,** the Spanish economy is posting **still-weak but positive quarter-on-quarter rates of change in GDP…**

- **…** while **IMF and market consensus GDP growth projections** are **at similar levels** for the Spanish economy as for **other euro area countries from 2012**





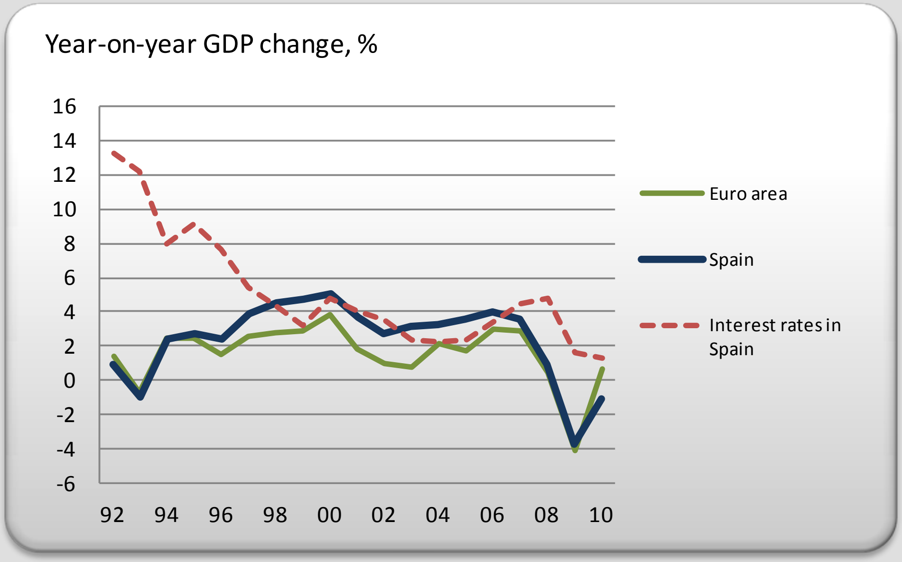


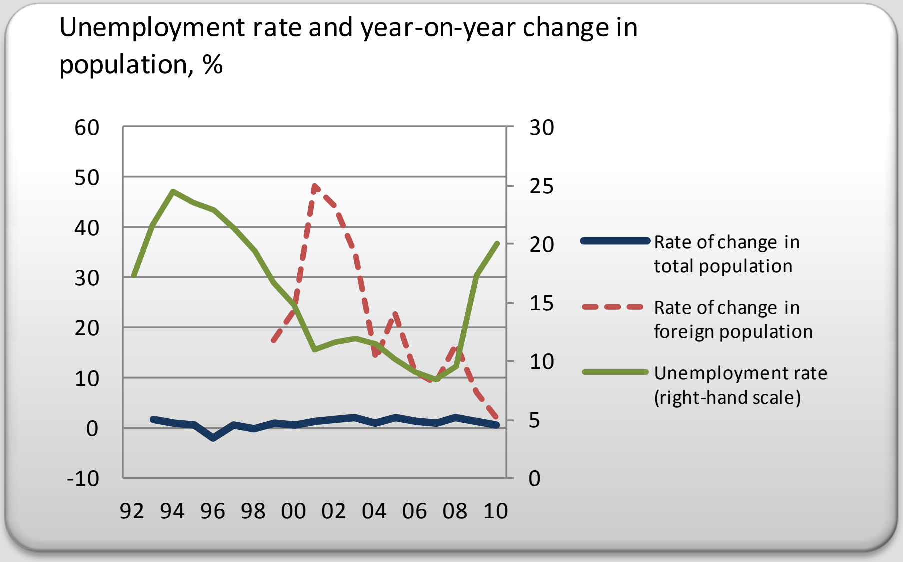
SOURCES: INE, Eurostat, IMF and market data

The Spanish economy in perspective

- **The current weakness of GDP** is due to the ongoing **adjustment of the previously mentioned imbalances**

  - Much of the adjustment is being made via **job destruction**, which denotes a **problem of the Spanish labour market**





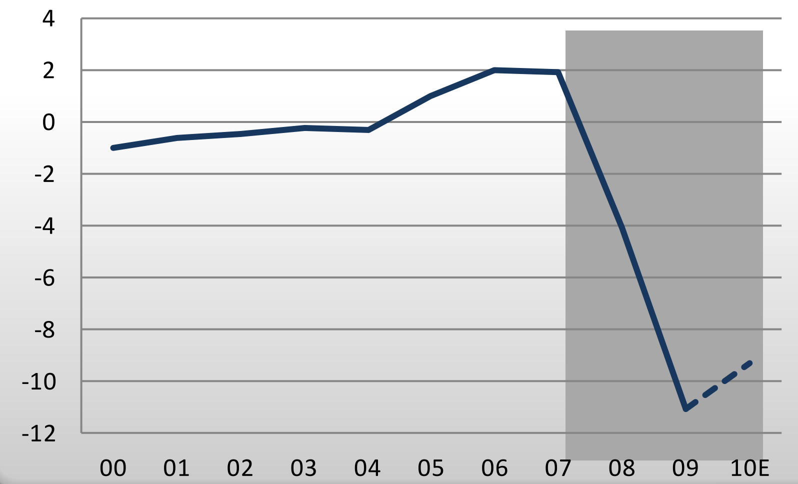
SOURCES: INE and Eurostat

The Spanish economy in perspective

- **The budget deficit has worsened** markedly

- Nonetheless, and thanks to a good starting position, and to the fiscal consolidation plan approved by the government, **IMF projections place Spain's debt/GDP ratio below that of other developed countries**

Spain's budget deficit as a proportion of GDP, %



2012 proyections, as a proportion of GDP

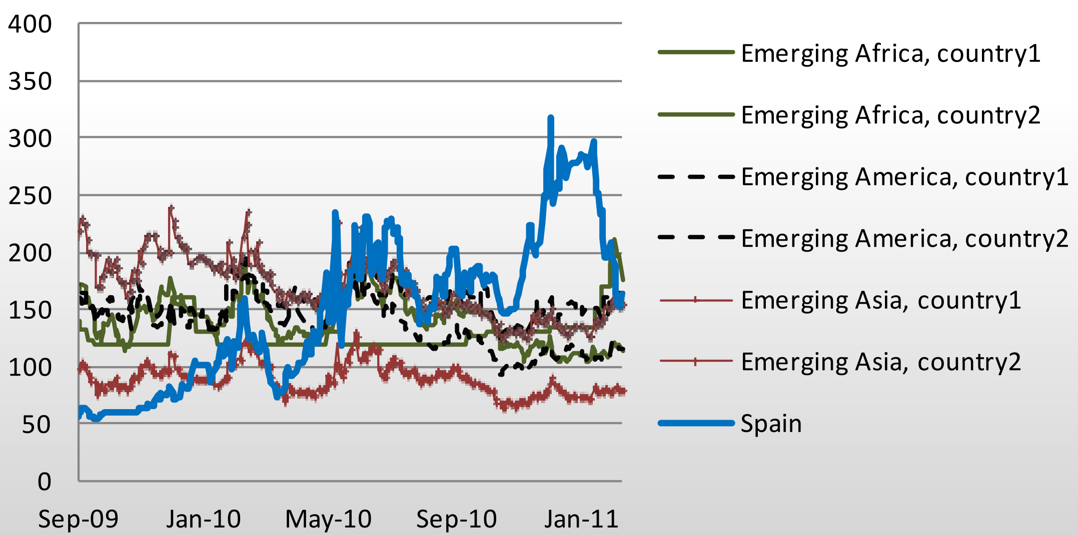
	Deficit	Cyclically-adjusted deficit	Public debt
USA	-7.2	-5.4	102
Euro area	-4.0	-3.1	88.7
France	-4.9	-3.8	89.4
Germany	-2.3	-2.2	77.1
Italy	-3.5	-2.3	120.1
Spain (a)	-6.0	-5	72.6
Japan	-8.0	-7	232.8
U. Kingdom	-6.1	-4.5	84.5
Canada	-3.3	-2.5	84.8

SOURCE: IMF

(a) The Spanish Government has established an unconditional objective regarding the fiscal deficit for years 2012 and 2013. In 2012 the objective of fiscal deficit over GDP is -4.4%, and in 2013, -3%.

- The markets have tended to correct, in part, the **overreaction seen in the public debt spread in the context of the sovereign debt crisis in the euro area**

5-year senior debt CDS, bp. Data to 7 February 2011



SOURCE: Datastream

The Spanish economy in perspective

- **Some of the imbalances are also centred on the real estate sector**

  - **House prices rose more in other countries** than in Spain (50pp more in Ireland and 20pp more in the UK)

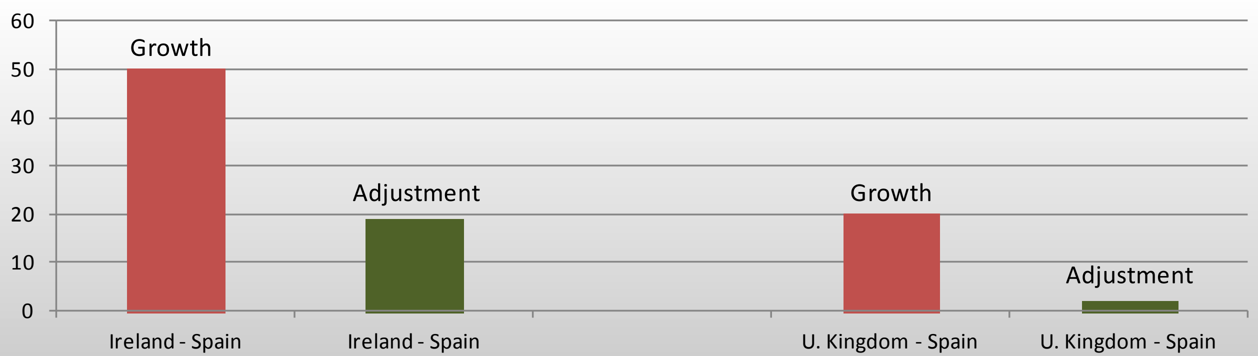
  - **The falls from the peaks** reached are also proving **greater in these other countries** (19pp more in Ireland and 2pp more in the UK)

  - Thus, comparatively, the degree of the adjustment in Spain is being harder than in other countries

Difference in housing prices growth from 1997 until the peak (pp)

Difference in housing prices adjustment from the peak until last available data (pp)

Note: differences are calculated as the difference between the growth rate of the corresponding country vis-à-vis Spain in both the growth phase and the adjustment phase



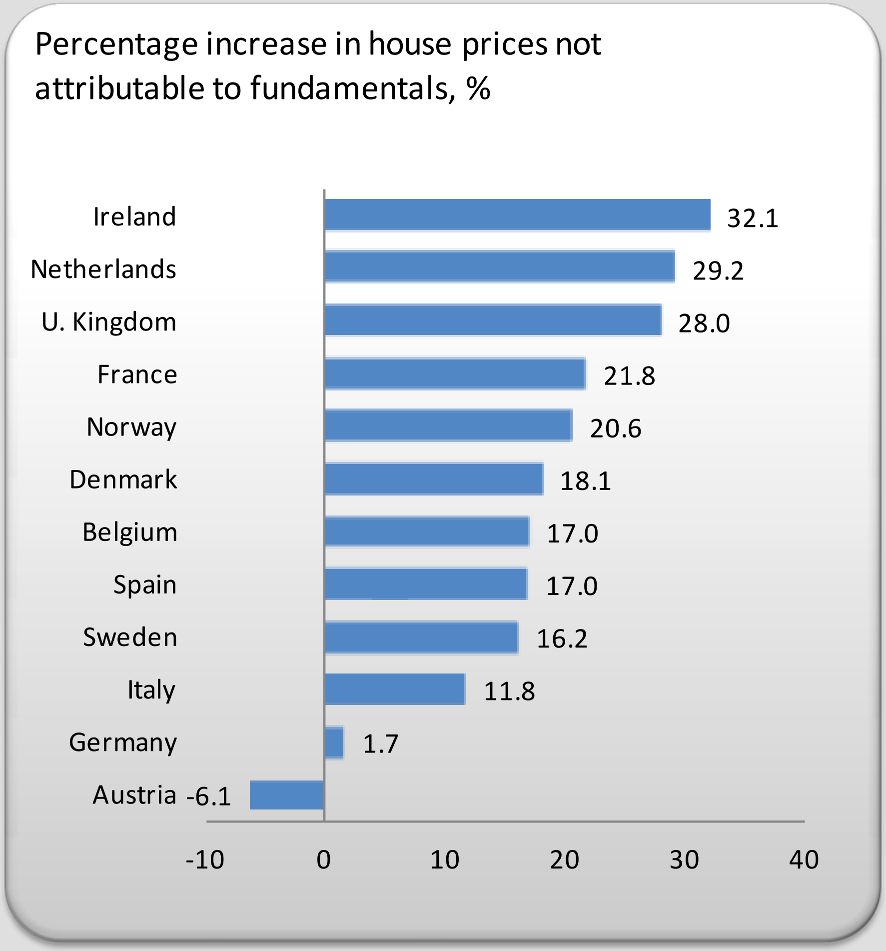
The Spanish economy in perspective

- The growth of house prices **in Spain evidenced a lower overvaluation component than that in other countries (IMF, April 2008)**

- **It was,** therefore, **largely based on fundamentals,** and this is reflected in a **lesser need for downward corrections in the current phase**

  - **Demographic and socioeconomic factors**

  - **Spanish euro area membership, with a permanent real interest rate reduction effect, implying a permanent increase in asset valuations**

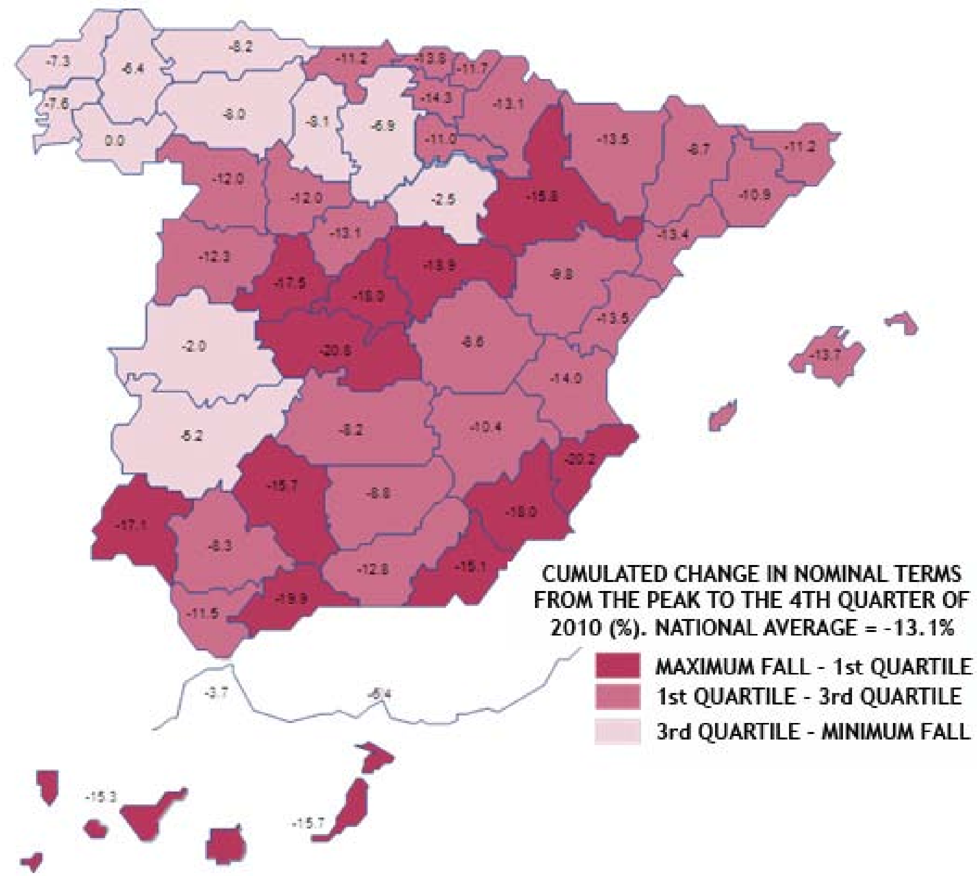


SOURCE: IMF, April 2008

The Spanish economy in perspective

- There has been an **18% adjustment in real terms** (13% in nominal terms) **in house prices in Spain from their peak** to 2010 Q4
  - This adjustment reflects the average figure, **consistent with sharper adjustments in different regions and market segments**
- This adjustment in prices is consistent with a volume of **new house transactions that has stabilised at around 225,000 units**

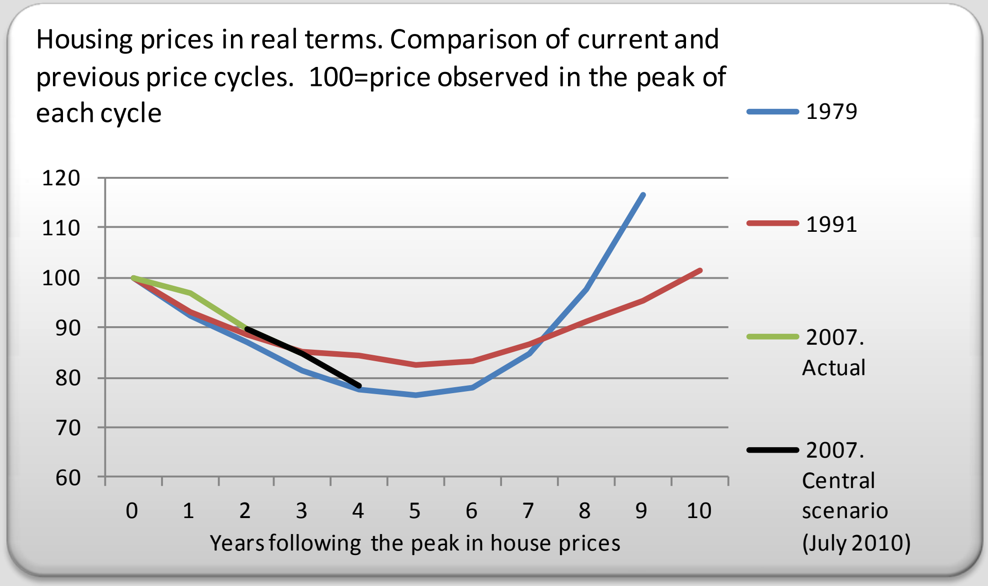
Provincial breakdown of the growth in house prices

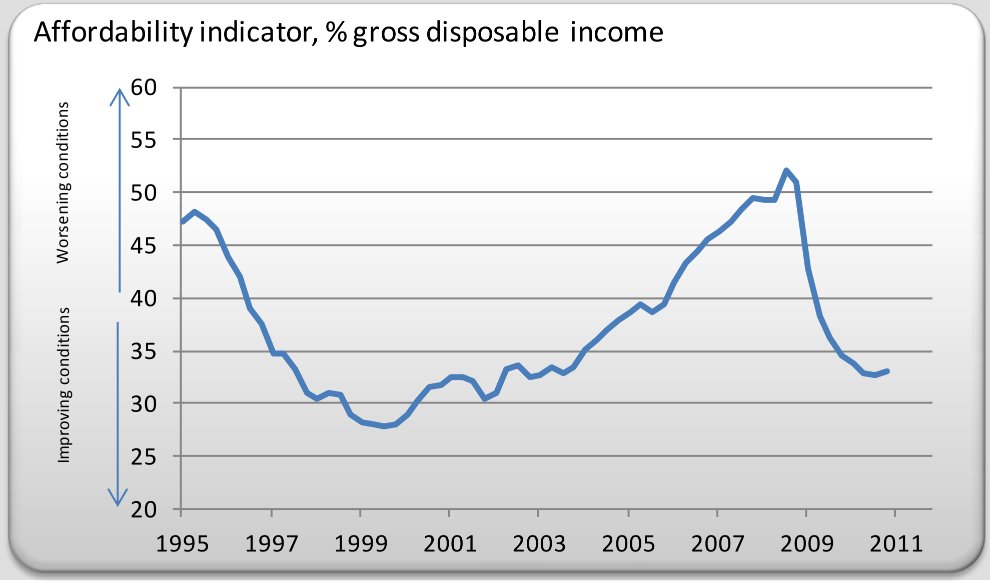


The Spanish economy in perspective

- The **price adjustment** is following a **similar pattern to that observed in previous cycles**

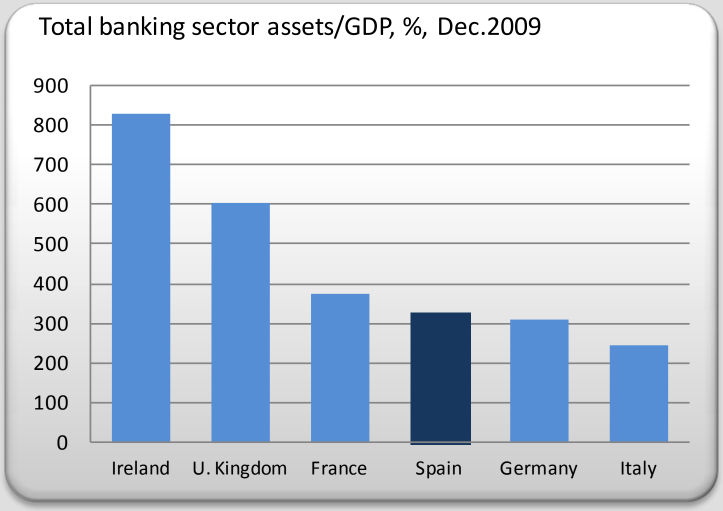
- **Affordability indicators for households** are once again **at historically low levels**





The Spanish banking sector in perspective

- The **weight of the banking sector is similar to that of other EU countries**
  - In Spain, the sector basically comprises commercial banks and savings banks

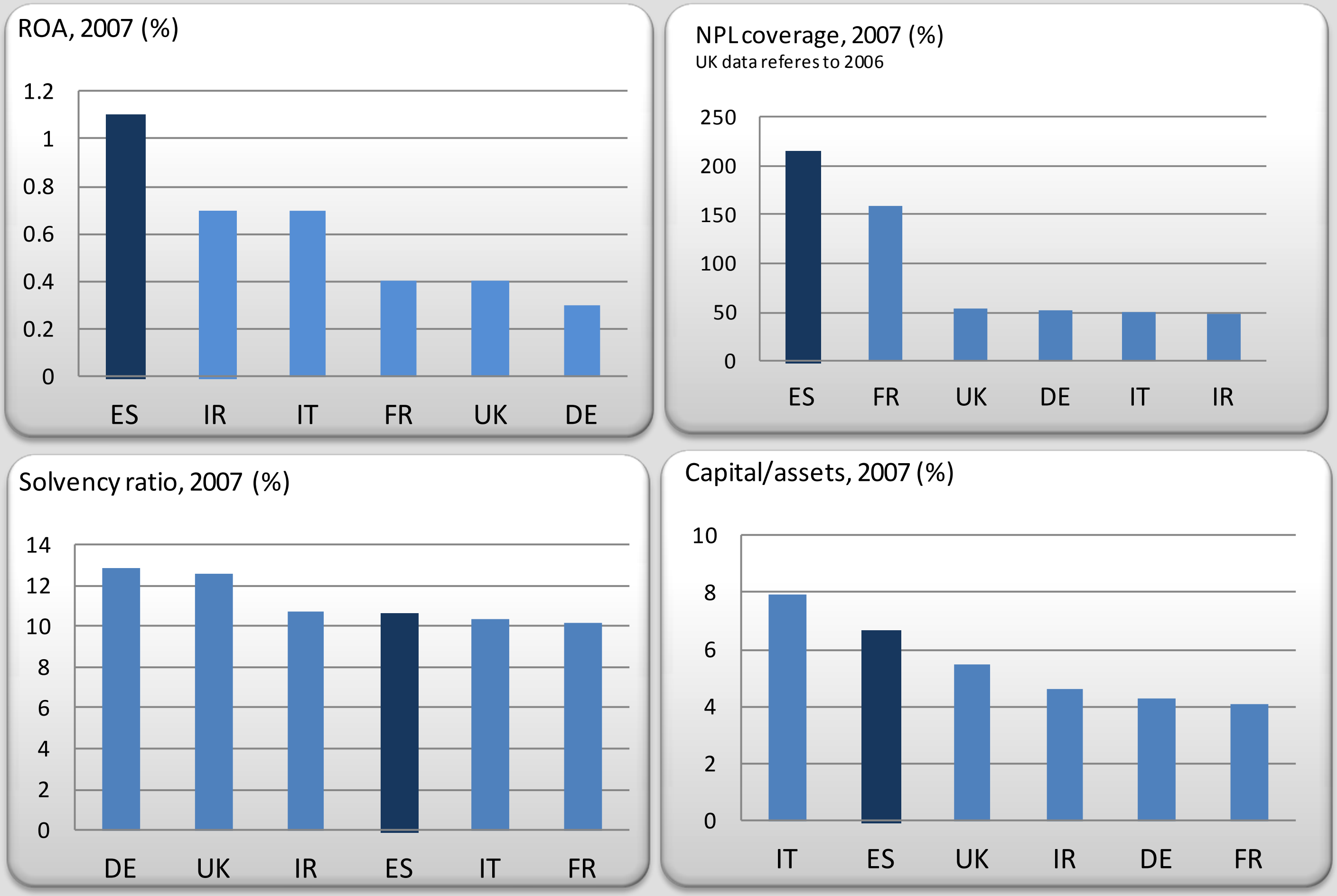


SOURCE: ECB

- **Spanish banks** pursue a **traditional retail banking model**
  - There is no originate-to-distribute model
  - No investment in/generation of toxic assets (CDOs, CDOs^2, …)
  - No conduits or SIVs were set up, since their consolidation would have been required
  - Prudent approach to wholesale funding; issuance towards the longest-dated terms available
  - Franchise value

The Spanish banking sector in perspective

- This is reflected in the **sector's good starting position before the international financial crisis in the summer of 2007**



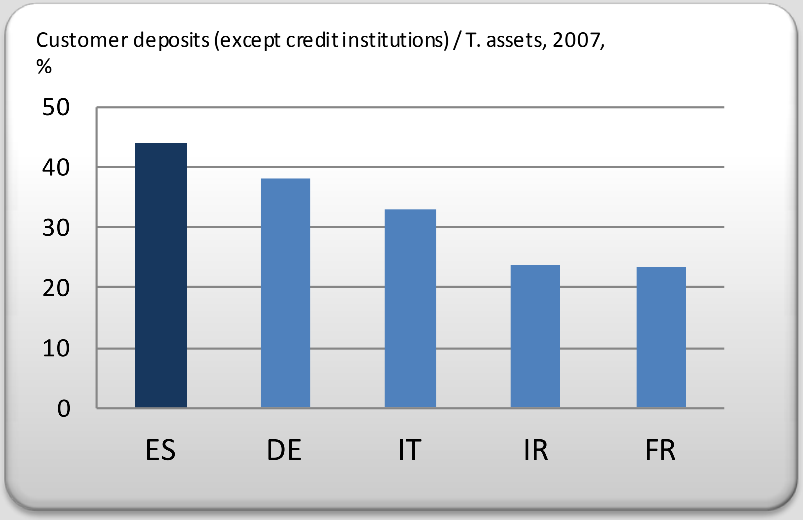
SOURCE: IMF (October 2010)

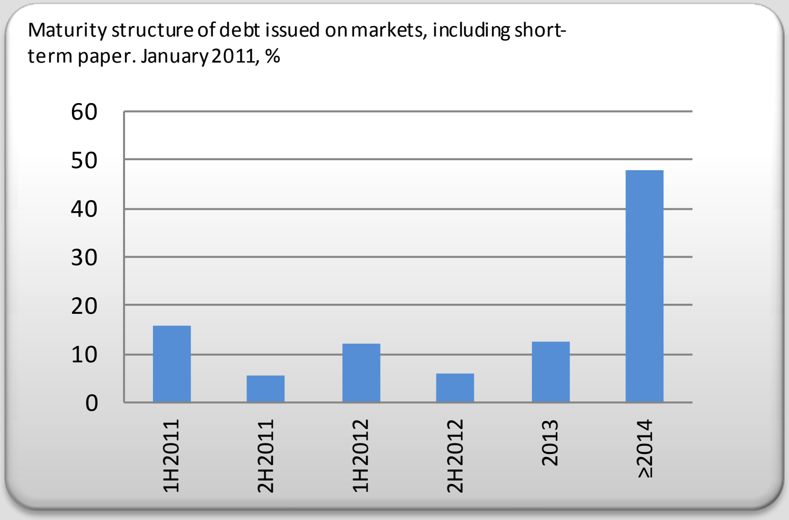
The Spanish banking sector in perspective

- The sector's good starting position was also evident regarding institutions' funding policies

  - **Solid retail deposit base**

  - **Issuance in the wholesale markets towards the longest-dated term, making for a maturity structure where maturities are mostly concentrated after 2014**

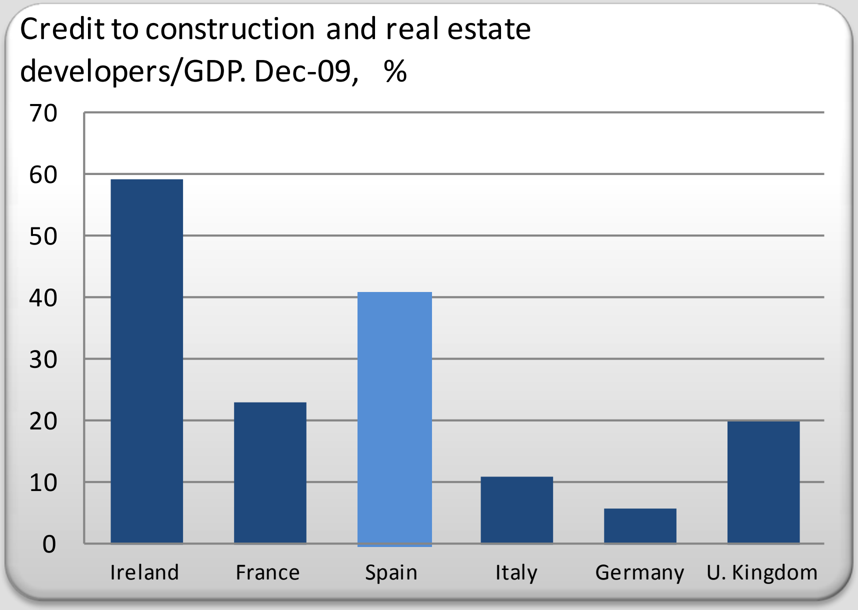




SOURCES: BdE and ECB

The Spanish banking sector in perspective

- The Spanish banking sector **built up weaknesses during the economy's upturn**
  - Sharp growth in credit, chiefly in the **construction and real estate developers** sector
  - **Excess capacity**



SOURCES: Eurostat and National Central Banks

- These imbalances have been **more acute for a number of savings banks**
  - **Expansion** outside their traditional **geographical** area
  - **Singular stakeholder model** that complicated their capacity of issuing equity

Impact of the crisis and measures adopted

- The **impact of the international financial crisis** on the Spanish banking sector, and therefore the measures adopted, can be characterised in **different periods**

  - The **first**, characterised by the **outbreak of the international financial crisis** and **resilience of Spanish banks** in the face of this first wave. Afterwards, the persistence of the crisis and the crisis in the real economy translates into the adoption of preventive measures regarding the Spanish the banking sector

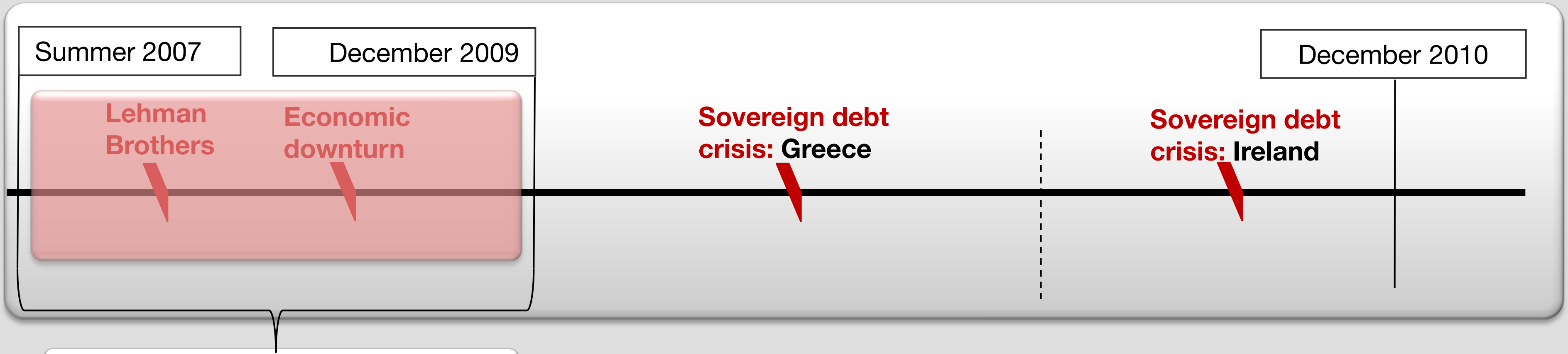
  - The **second**, characterised by the sovereign debt crisis in the eurozone in the first half of year 2010, which led to the publication of stress tests, the tightening of provisioning requirements and amendment of the savings banks law

  - And a **third stage**, since summer 2010, characterised by a fresh spike in the **sovereign debt crisis** which in Spain leads to much higher transparency requirements and finally to the measures adopted under the **recently approved Royal Decree-Law**

- **Over this period, Spanish banks have already recognised asset impairments** for an amount equivalent to a nearly **9% of GDP**

Impact of the crisis and measures adopted

First period



- **Resilience**
- **Start of economic crisis**

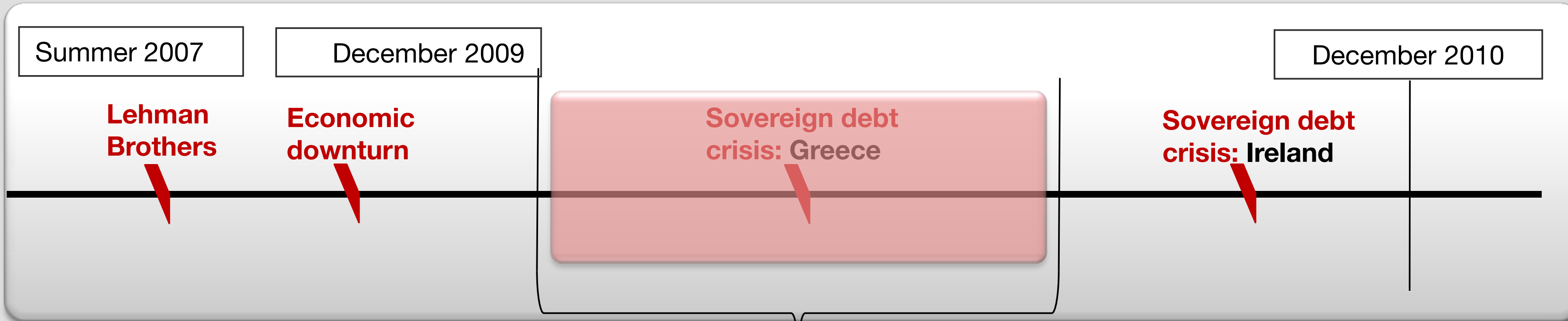
✓ **Granting of guarantees for banks issuances of new debt and the creation of the fund for the acquisition of high-quality assets**

✓ **The Eurosystem approves to meet all the demands for liquidity (full allotment)**

✓ **Creation of Fund for the Orderly Restructuring of the Banking Sector (FROB), with capacity to obtain funds totalling €99bn**

Impact of the crisis and measures adopted

Second period



- **Sovereign debt crisis in the euro area**
- **Weakness of the economy**
- **Doubts** over the **quality** of **real estate assets**

✓ **Stress testing**

✓ **Tightening of provisions**

✓ **Reform of savings banks legislation**

✓ **Completion of savings banks mergers and concentration process**

Second period

July 2010 stress tests (1)

- The stress tests in Spain were marked by the **high degree of transparency and the severity of the parameters applied**

- There was **capital available in Spain, via the FROB,** for those banks that did not pass the tests and that could not obtain private capital

  – *There were some savings banks that did not pass the stress tests*

  – *This was a reflection of the severity of the tests, both regarding the parameters and the degree of coverage, since virtually the entire banking sector was included*

Impact of the crisis and measures adopted

Second period

July 2010 stress tests (2)

- **The stress tests were very transparent**
  - All listed banks and all savings banks were tested, entailing 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 institution taking part in the exercise
    - *Portfolio composition*
    - *Provisioning and fiscal impact*
    - *Dividends and fair value of merger processes*
    - *Breakdown of public aid received before the tests*

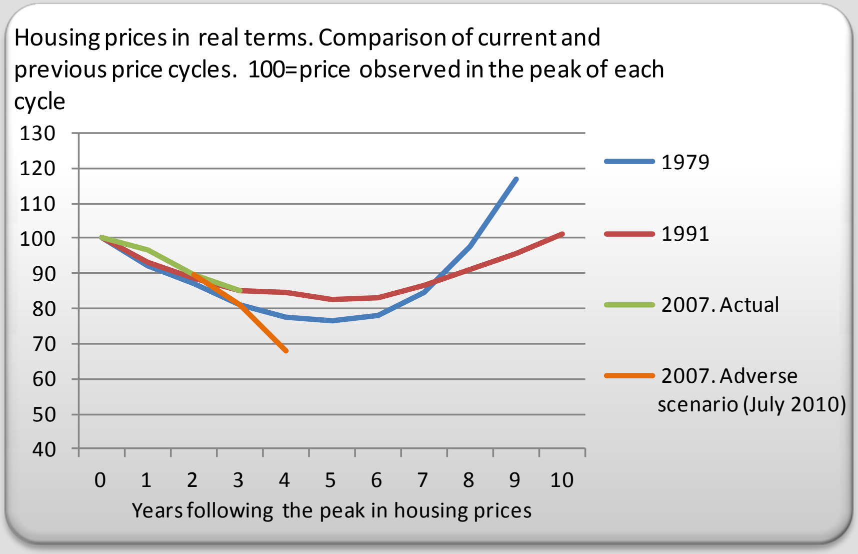
		Stressed benchmark scenario		Adverse stressed scenario	
		€ million	% assets	€ million	% assets
Credit assets					
	Financial institutions				
	Corporates				
	Property developers and foreclosures				
	SMEs				
	Mortgages				
	Other retail				
Impact sovereign risk and others					
GROSS IMPAIRMENT					
PROVISIONS	**Specific**				
	General				
NET OPERATING INCOME AND CAPITAL GAINS					
TAX IMPACT					
NET IMPAIRMENT					

	Stressed benchmark scenario		Adverse stressed scenario	
INITIAL SITUATION 2009	**€ million**	**% RWA 2009**	**€ million**	**% RWA 2009**
Tier 1 dic 2009				
FINAL SITUATION 2011	**€ million**	**% RWA 2011**	**€ million**	**% RWA 2011**
Net impairment				
Dividend, fair value of mergers and others				
Tier 1 Dec 2011 without FROB				
Committed FROB				
Tier 1 Dec 2011				
Additional capital to reach Tier1 6%				

	Stressed benchmark scenario	Adverse stressed scenario
DGF Support		
Committed FROB		
Additional Capital to reach Tier1 6%		
TOTAL		

Impact of the crisis and measures adopted
Second period
July 2010 stress tests (3)

- **... and demanding in terms of the parameters used:**
  - **Decline** of 2.6% **in GDP** in the period analysed, on top of a decline of 3.6% in 2009
  - Highly significant **reductions** in **collateral values**
    - *–28% for finished houses,*
    - *–50% for houses under development*
    - *–62% for land*
    - *– Price developments have been better in reality than those considered in the stress tests*

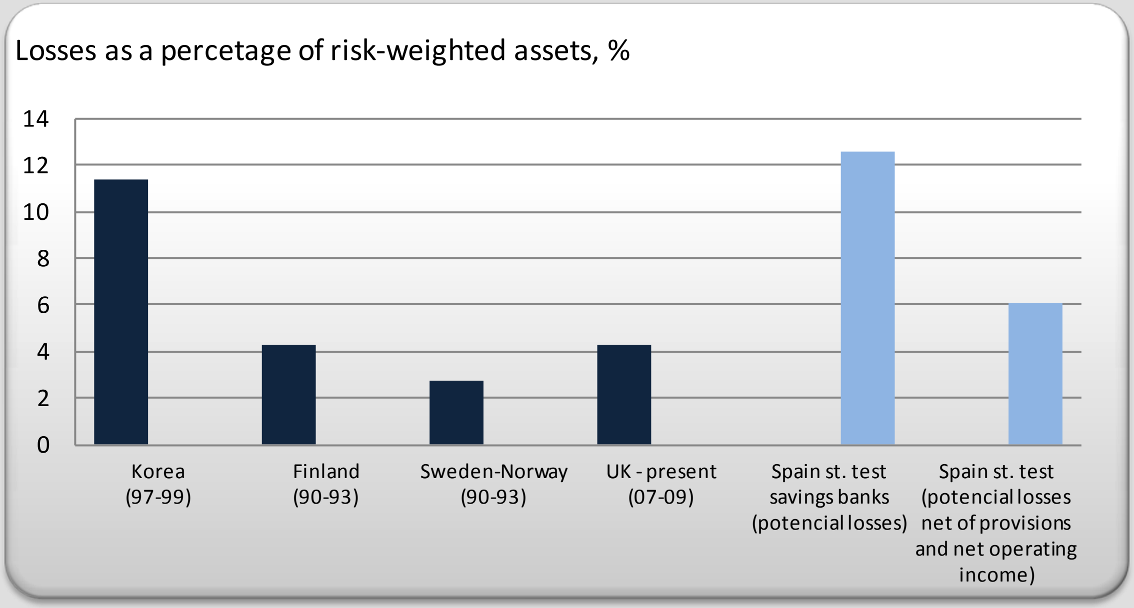


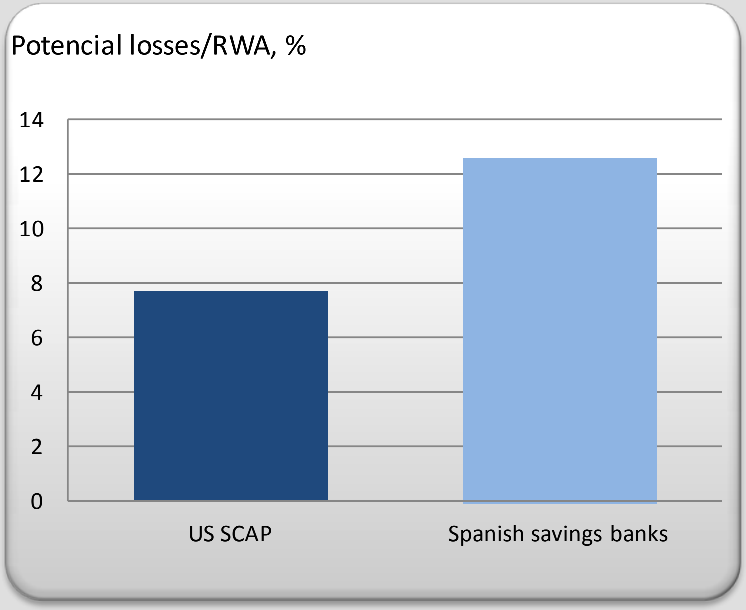
- **Reduction in profits before provisions** which, for savings banks, resulted in a net operating income before provisions that was 37% lower than the average over the past 20 years
  - *– In the US stress tests, the profit margin was 15% lower than the average margin for the past 20 years*

Second period

July 2010 stress tests (4)

- **The severity of the parameters translates into potential high losses in the adverse stressed scenario**
  - The assumptions considered in the adverse scenario resulted in **high levels of losses compared with those recorded in other past crises and with those obtained in the US stress tests**





SOURCES: Bank of England, US SCAP and BdE

Second period

Tightening of provisioning (1)

- In Spain, provisioning rules are straightforward and transparent
  - The regulator sets **minimum criteria**, and their **compliance** is **verified** by the **supervisor** and by banks' **external auditors**
    - *In other countries, provisions are decided by the banks with the approval of the external auditors*
  - For assets that are collateralised, significant haircuts are applied taking the lower between the loan value and the appraisal value (market value)
    - *It is not the ordinary practice to apply these haircuts; rather, market value is considered*
- In summer 2010, **provisioning rules** were tightened **for two reasons**, at a time when banks were already assuming high provisions as loans went into arrears:
  - *To accelerate the coverage of non-performing loans*
  - *To give banks incentives to place foreclosed assets or assets received in payment of debt on the market*

Impact of the crisis and measures adopted
Second period
Tightening of provisioning (2)

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

- **Realistic haircuts in collateral values**

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

▪*Borrower's principal dwelling:*	*20%*
▪*Commercial and industrial premises and multi-purpose offices:*	*30%*
▪*Other finished houses (real estate developers):*	*40%*
▪*Developable land parcels and building plots (real estate developers):*	*50%*

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

  – *Provisions of 10% are set at the time of foreclosure based on 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*

Second period

Tightening of provisioning (3)

- **Provisions and asset valuation**

  - Discussion on asset valuation turns on two aspects: **losses already incurred** and **potential losses in a stressed scenario**

  - The **losses already incurred** are covered by **provisions**

    –Neither on the basis of their volume (which accounts for nearly a 9% of GDP) nor of their calculation (transparent, regulated and prudent) can it be sustained that there is a shortfall in the recognition of losses incurred

  - In the case of **potential losses under stressed scenarios,** scenarios with a **very low probability of occurrence** are considered. In fact, the July 2010 stress testing scenarios have not materialised

    – One of the key variables in these exercises is the assumption on loss given default (LGD), which is affected by the LTV and by the assumptions of a fall in price of the underlying assets

    – Not to take into account the LTV means adopting the assumption, which is not sustained by the evidence available, that this LTV is 100%

Impact of the crisis and measures adopted
Second period
Tightening of provisioning (4)

- **Provisions and asset write-downs in savings banks' real estate developers and construction portfolio:**

  - For savings banks, in the case of their exposure to the real estate developers and construction portfolio (€217 bn), a **46% of this (€100 bn) is classified as potentially problematic.** This amount comprises:

– Standard loans under surveillance:	*€28 bn*
– Doubtful loans:	*€28 bn*
– Foreclosures:	*€44 bn*

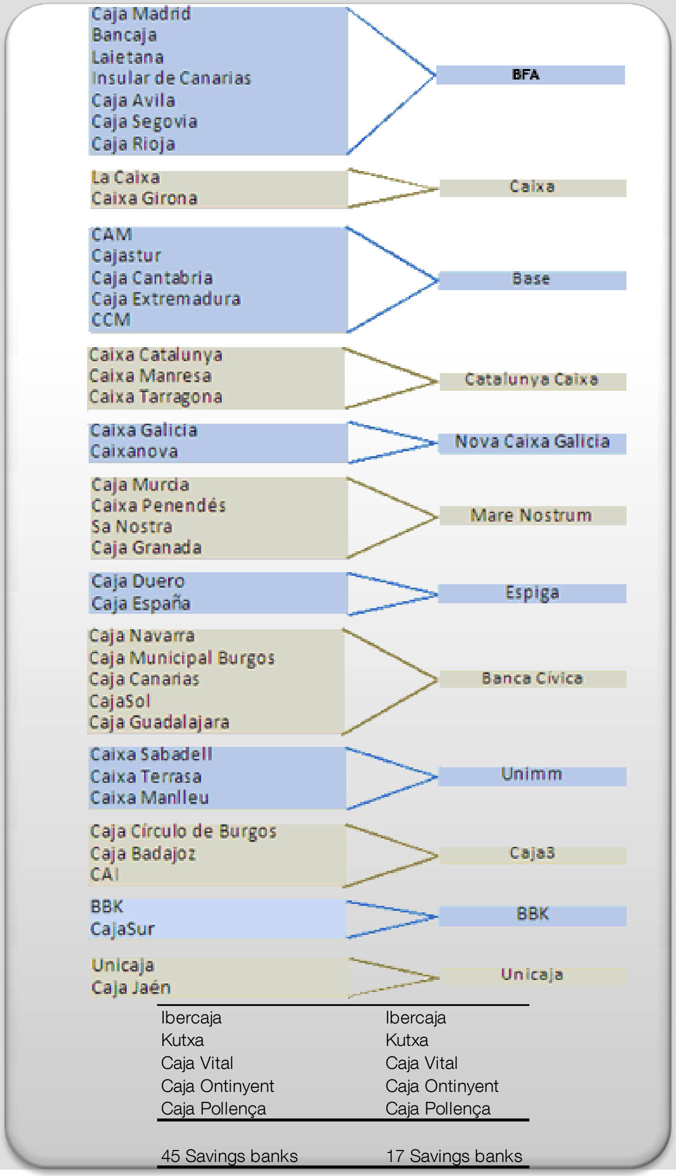
  - The **specific provisioning** set aside at present accounts for **31% of this potentially problematic exposure**

  - **If the general provisions are added,** coverage would rise from 31% to **38%**

Impact of the crisis and measures adopted
Second period

Actualizar nombres

- **Amendment of the Savings Bank Law**
  - Allows savings banks to **issue top-quality capital,** facilitating their access to the capital markets
  - **Contributes** to making their management and governing bodies **more professional**
  - Subjects savings banks to **greater market discipline**
- **Culmination of the process designed in the FROB Royal Decree**
  - **From 45 to 17 savings banks**



Impact of the crisis and measures adopted
Third period

- **In the summer the wholesale markets reopened** for Spanish banks,
- **… but economic weakness persists and the pressure on Irish debt** generates contagion effects. Potential access to wholesale markets is once again made harder

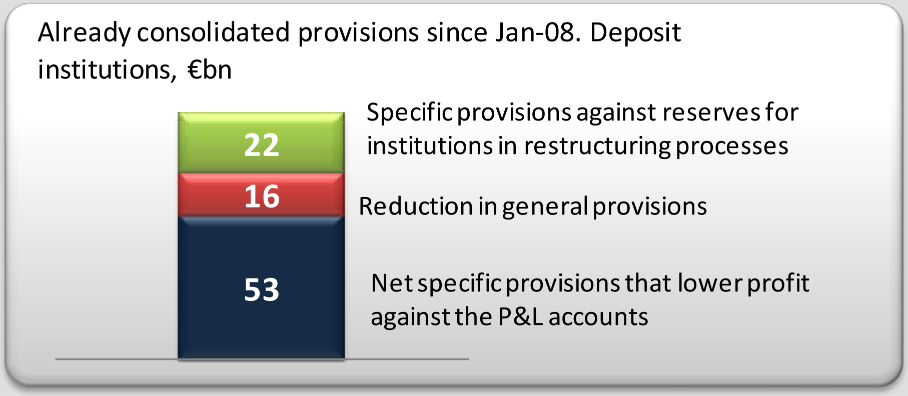
✓ **More transparency**

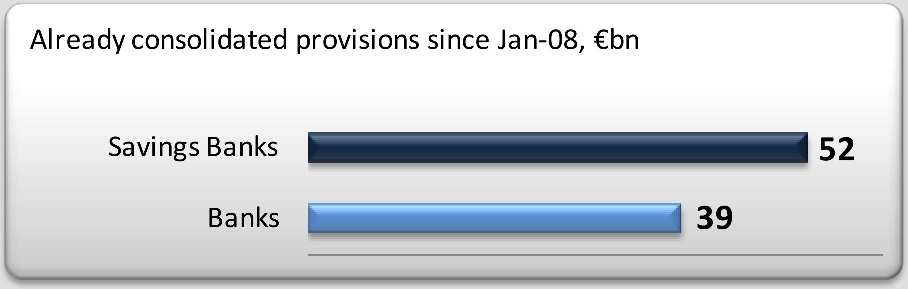
✓ **Increase in capital requirements (8%-10%) with the backing of the FROB if funds are not obtained in the market**

The banking sector at end-2010

Recognition of problems by banks (1)

- **Since January 2008, the banking sector has recognised and assumed asset impairment losses for an amount equivalent to nearly 9% of GDP**
  - €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 through the FROB





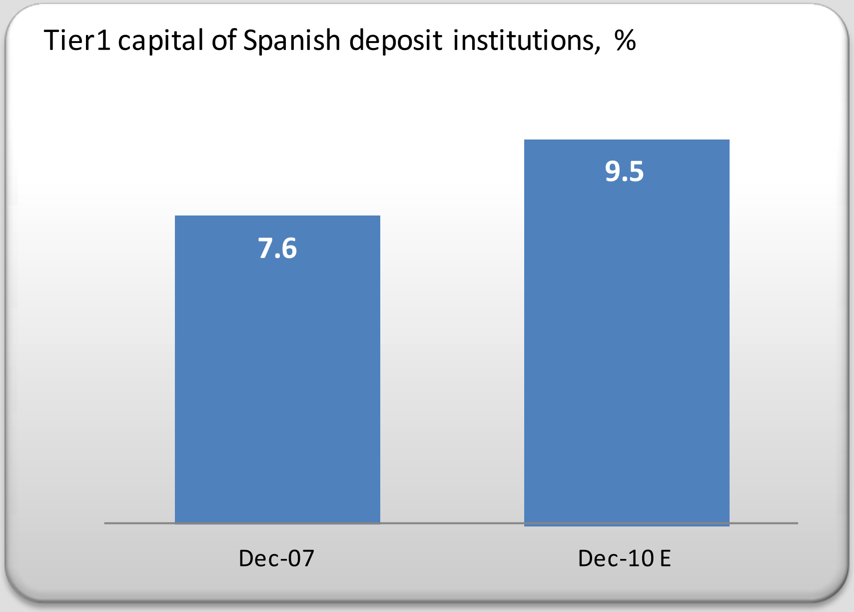
The banking sector at end-2010

Recognition of problems by banks (2)

- Spanish institutions have also reinforced their capital over the course of this period

- The increase in the excess of Tier1 capital relative to the requirements accounts for around 3.7% of GDP

- Thus, adding of accumulated provisions and the excess of capital over the minimum along this period represent nearly a 13% of GDP

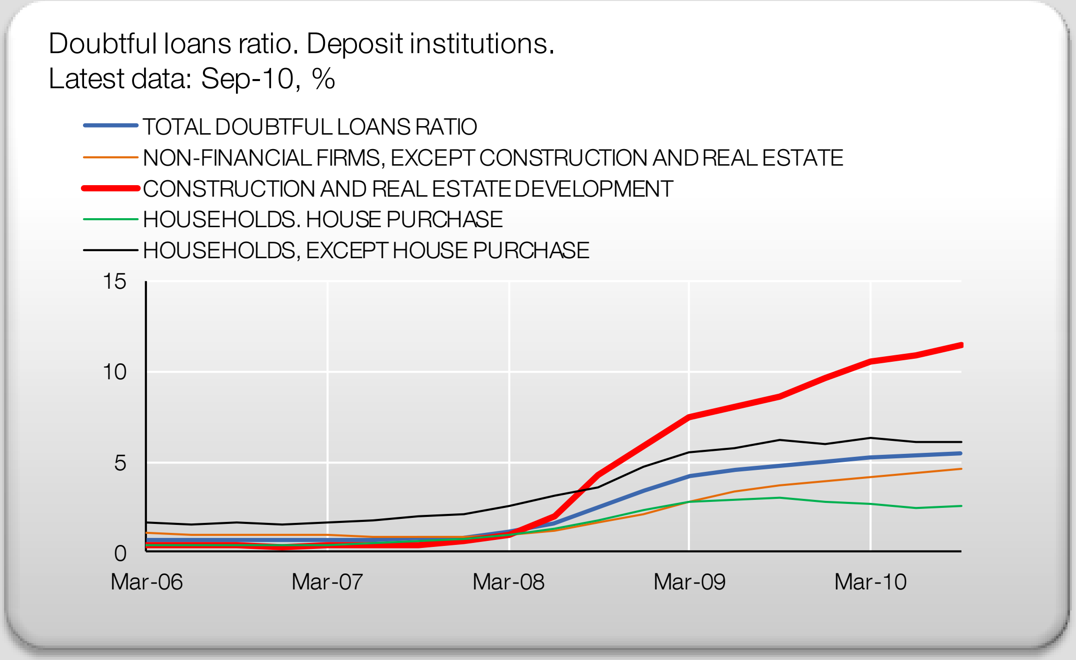


Impact of the crisis and measures adopted

The banking sector at end-2010

Credit portfolio, construction and real estate developers (1)

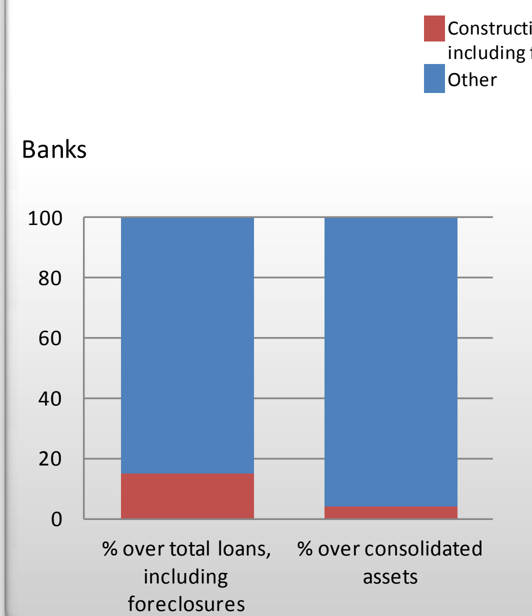
- **These corrections in asset value are largely due to the loans related to the real estate developers and construction sector, whose doubtful assets ratio is growing significantly more than in the rest of the portfolio**

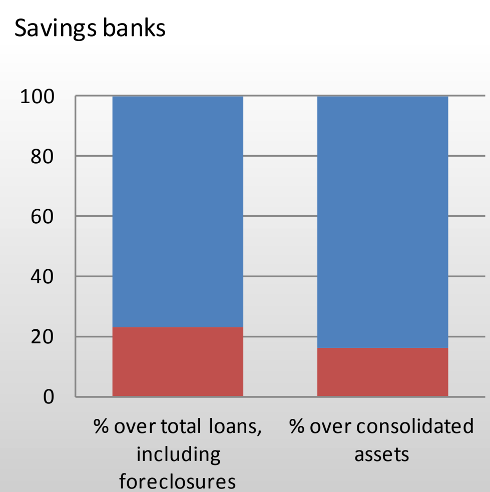


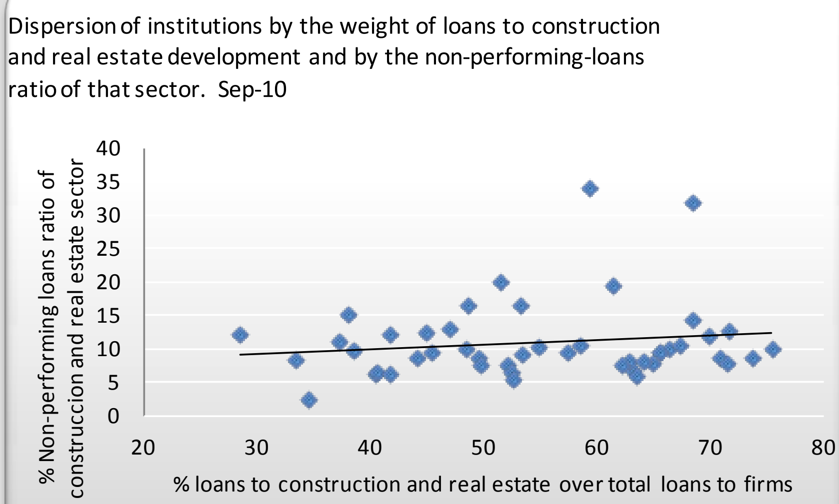
The banking sector at end-2010

Credit portfolio, construction and real estate developers (2)

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







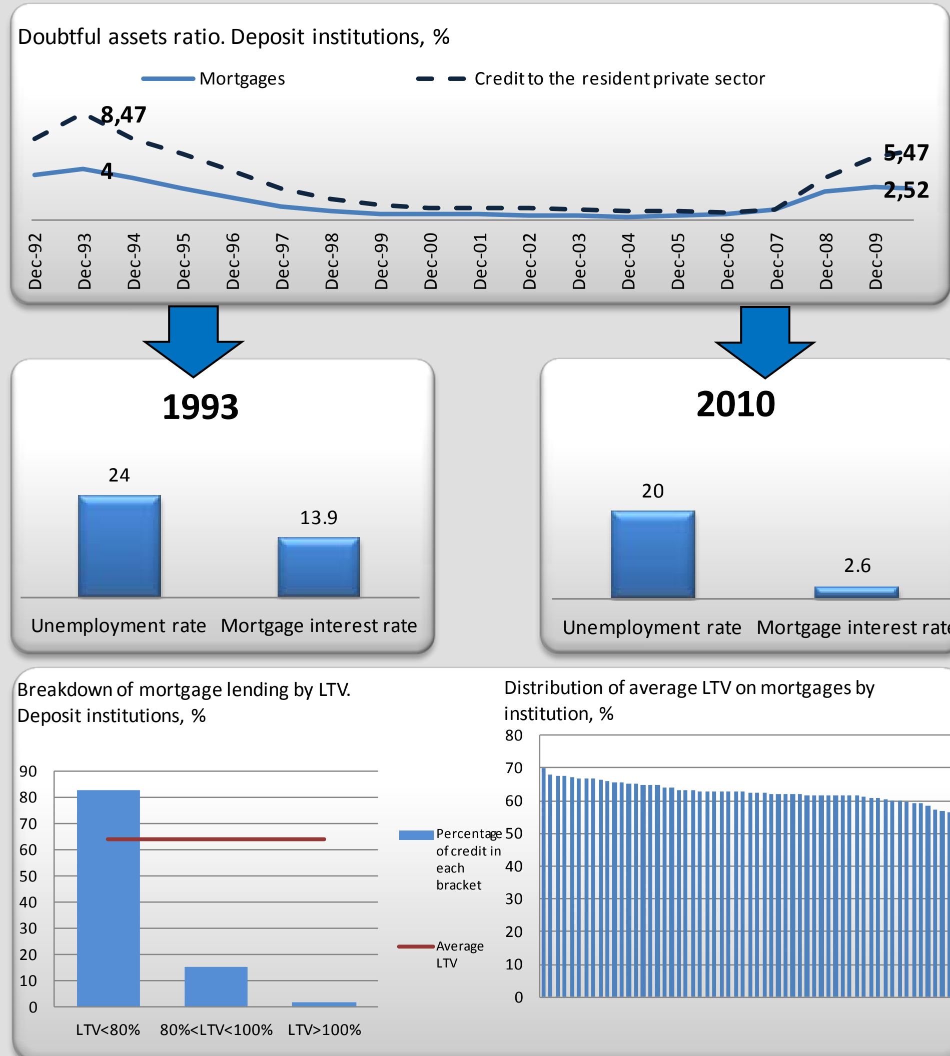
NOTE: The banks depicted account for close to 90% of deposit institutions' total assets

Impact of the crisis and measures adopted

The banking sector at end-2010

Retail mortgage portfolio

- **Despite the real estate market adjustment in Spain, the retail mortgage portfolio does not pose a material problem**
  - Its default rate is, and has historically been, 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



Impact of the crisis and measures adopted

The banking sector at end-2010

Profitability (1)

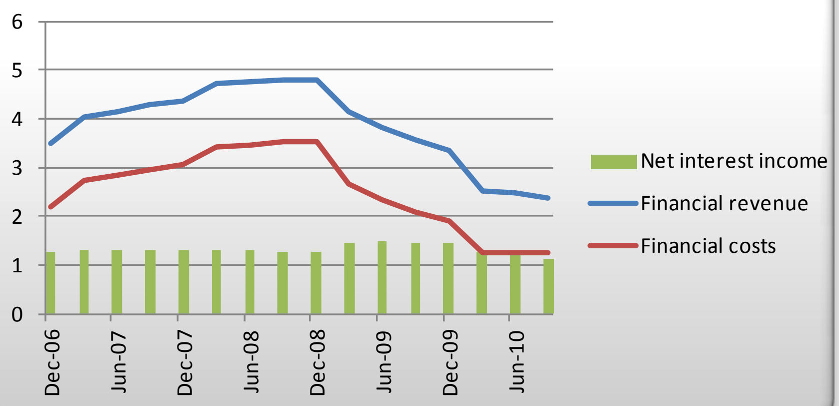
- **P&L accounts will remain under downward pressure** in the coming quarters

  - The cost of funding remains high

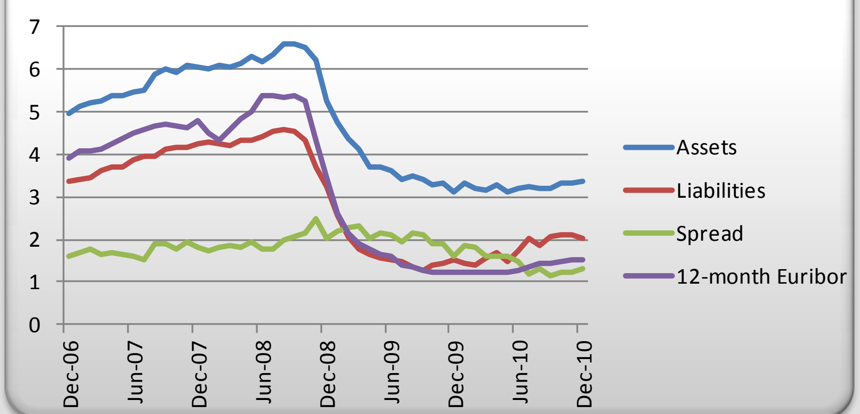
    – *Although it places downward pressure on spreads for new business, it passes through slowly to average rates and, therefore, to net interest income*

    – *This is a parsimonious process that is only worrying if these trends hold in the medium term*

Net interest income/ATA. Deposit institutions, business in Spain, %. Data to Sep-10



Weighted marginal interest rates. Deposit institutions, %. Data to Dec-10



The banking sector at end-2010

Profitability (2)

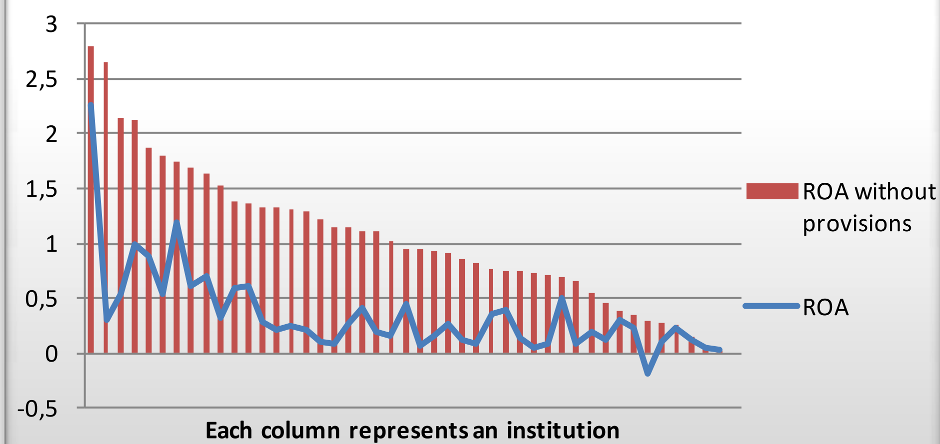
- **In any event, banks' core business remains profitable looking ahead**

  - **Spanish banks are efficient,** and the merger and concentration processes – via cost savings – have a positive influence on this dimension

  - Institutions, and savings banks in particular, have a **high franchise value** and product cross-selling capability, underpinned by their proximity to customers

  - **Activity will become more dynamic as the recovery in the economy gathers pace** (recall IMF forecasts)

ROA and ROA without provisions, Sep-10, %



NOTE: Institutions represented account for more than 94% of deposit institutions' total assets

Impact of the crisis and measures adopted

The banking sector at end-2010

Funding (1)

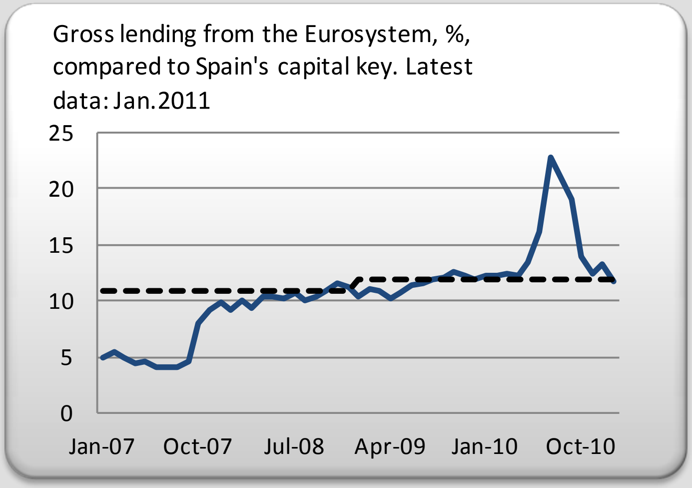
- **As indicated, the sovereign debt crisis in the euro area has resulted in the wholesale funding markets closing**

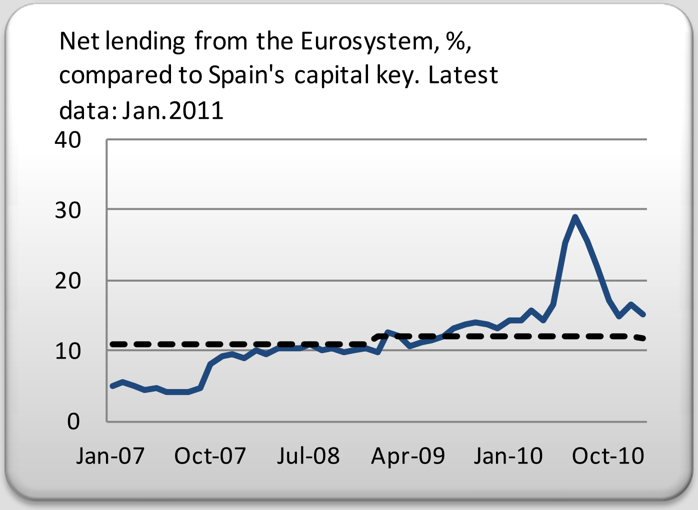
  - Spanish banks have resorted to Eurosystem funding to a greater extent than in the past

  - 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…***

    - ***which confirms that when the opportunity arises, Spanish banks tap the wholesale markets for funding***





NOTE: Net lending is defined as the difference between the liquidity injected and the funds deposited in the liquidity absorbing operations

The banking sector at end-2010

Funding (2)

- **Notwithstanding the fact banks should continue to manage their business appropriately, the structure of savings bank funding shows that stable disposable funding stands at 100.1% in relation to stable funding needs**

Net Stable Funding. Savings banks' balance sheet, €bn

Customer loans	870	Own funds	47
Investments	30	Wholesale funding with maturity of more than 1 year	273
Other net assets	5	between 1 year and 2 years	62
		between 2 and 5 years	109
		more than 5 years	102
		Retail funding	590
Stable funding needs	904	Stable funding sources	911
Liquid securities	117	Wholesale funding with maturity of less than 1 year	129
Balances at central banks	19		
Total	1040	Total	1040

Impact of the crisis and measures adopted
Third period: new measures
Transparency (1)

- The Banco de España has required banks to publish full details of their lending to the construction and real estate developers sector
  - *Publication has exceptionally been brought forward for savings banks to January*
  - *All institutions will have to publish the information in their annual accounts, which will require verification by external auditors*

Impact of the crisis and measures adopted
Third period: new measures
Transparency (2)

- **The information already published by Spanish savings banks is very detailed, in particular concerning their construction and real estate developers portfolio**

Savings banks	Exposure	% of exposure	% of total credit risk
Credit risk	173	80%	18%
Standard	117	54%	12%
Finished housing	50	23%	5%
Housing under construction	26	12%	3%
Land	22	10%	2%
Other	19	9%	2%
Standard under surveillance	28	13%	3%
Finished housing	7	3%	1%
Housing under construction	4	2%	0%
Land	10	5%	1%
Other	7	3%	1%
Doubtful	28	13%	3%
Finished housing	9	4%	1%
Housing under construction	5	2%	1%
Land	7	3%	1%
Other	7	3%	1%
Foreclosures	44	20%	4%
Finished housing	18	8%	2%
Housing under construction and other	3	1%	0%
Land	23	11%	2%
TOTAL EXPOSURE	217	100%	22%

Note. Savings banks have published a total figure for exposure to this sector of €205 billion, aggregating the data submitted by each institution, instead of the €217 billion reflected in this table. The difference is due to divergent data presentation criteria. Thus, for example, in this table undrawn loans, such as financial guarantees and drawable credit, are included, and the amounts for foreclosures are given as the value of the loan at the time prior to foreclosure.

Impact of the crisis and measures adopted

Third period: new measures

Transparency (3)

- The figure for savings banks' total exposure to the construction and real estate developers sector (€217 bn) is lower than the figure published at the time of the July 2010 stress tests (€303 bn). The reasons are:

  - Changes in the portfolio between July and December (€-10 bn)

  - The remainder is a result of the process of greater transparency set in place from that date by the Banco de España and by institutions involving the use of stricter methods of allocation to each portfolio, more closely in line with the actual exposure and the nature of the loan and the customer. From the stress test figure, then, the following should be discounted:

    - €27 bn allocated to civil engineering and public works

    - €16 bn allocated to large corporations collateralized with real estate assets

    - €33 bn allocated to SMEs collateralized with real estate assets

Third period: new measures

Transparency (4)

- To compare the figure of €217 bn for exposure to construction and real estate developers with that published quarterly in the Banco de España *Statistical Bulletin* (SB) (€230 bn in September 2010, the latest figure available), the following should be taken into account:

  - The SB does not include foreclosures (€44 bn) nor financial guarantees and drawable credit (€14 bn)

  - However, the SB does cover real estate developers and construction in a broad sense of the term, therefore including an amount of €66 bn corresponding to activities not strictly related to housing construction

  - Finally, from September 2010 to December 2010, there was a change in the portfolio of the order of €-5 bn

- The information published by the Financial Stability Report (FSR) follows analogous criteria to those of the SB

  - In fact, Box 2.3 of the March 2010 FSR indicated that the data published there on construction and real estate developers was an upward biased estimate. In particular, the Box stated “It has been decided to treat both sectors jointly because the boundaries between the two, in terms of statistical classification, are occasionally blurred”

Third period: new measures

Transparency (5)

- The latest FSR has published an amount of potential problem exposures for total deposit institutions of €180.8 bn (June 2010)
  - These data represent 35.2% of the total exposure of Spanish deposit institutions to real estate developers and construction as at June 2010
  - The level of coverage, including generic provisions, was 33%

- The data published by the savings banks (December 2010) show:
  - Potential problem exposures of €100 bn
  - This level of potential problem exposures represents 46% of the total exposure to construction and real estate developers
  - Its level of coverage at December 2010, including general provisions, is 38%

Third period: new measures

New Royal Decree-Law (1)

- **New capital requirements**
  - **Credit institutions are required to have a core capital ratio of at least 8%**
    - *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*

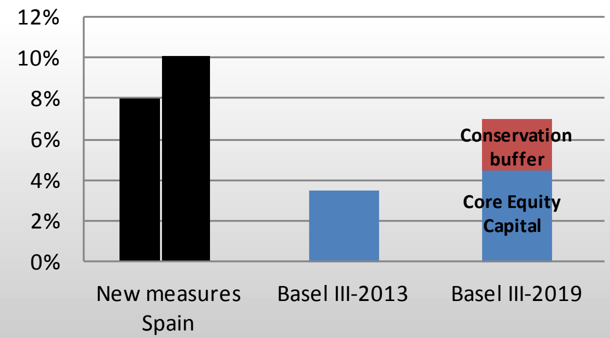
Definition of core capital: new measures approved

\+ 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



Impact of the crisis and measures adopted

Third period: new measures

New Royal Decree-Law (2)

- **New capital requirements**

  - **The requirement of a core capital ratio of 8% will be raised to 10% for those credit institutions meeting 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***

  - For all purposes, 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, all Spanish banks will operate with a core equity capital ratio of at least 8%***

Third period: new measures

New Royal Decree-Law (3)

- **New capital requirements**

  - **Once institutions have reached the new minimum requirements (8%-10%) depending on each particular case, if their core capital falls below minimum requirements at a maximum of 20%, then**

    – ***there are certain restrictions in terms of profit distributions in the form of dividends, variable remunerations, retribution of preference shares or share buy-backs …***

    – ***… in line with the idea of the conservation buffer in Basel III***

    – ***… but requiring a higher minimum requirement (at least 6.4%) with respect to Basel III-2013 (4.5% in this case)***

Impact of the crisis and measures adopted

Third period: new measures

New Royal Decree-Law (4)

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

  - The requirements of higher capital ratios imply an extra cushion for credit institutions: in times of uncertainty this is the best way to reinforce market confidence

  - The requirement is based on core capital because, after the approval of Basel III, core capital is clearly the new market and regulatory reference

  - A much higher core capital requirement (8%-10%) with respect to that approved by the Basel Committee for year 2013 (3.5%) means Spanish institutions are operating well above this international minimum requirement

  - The franchise value of savings banks, which is particularly strong in their traditional regions of origin, is retained

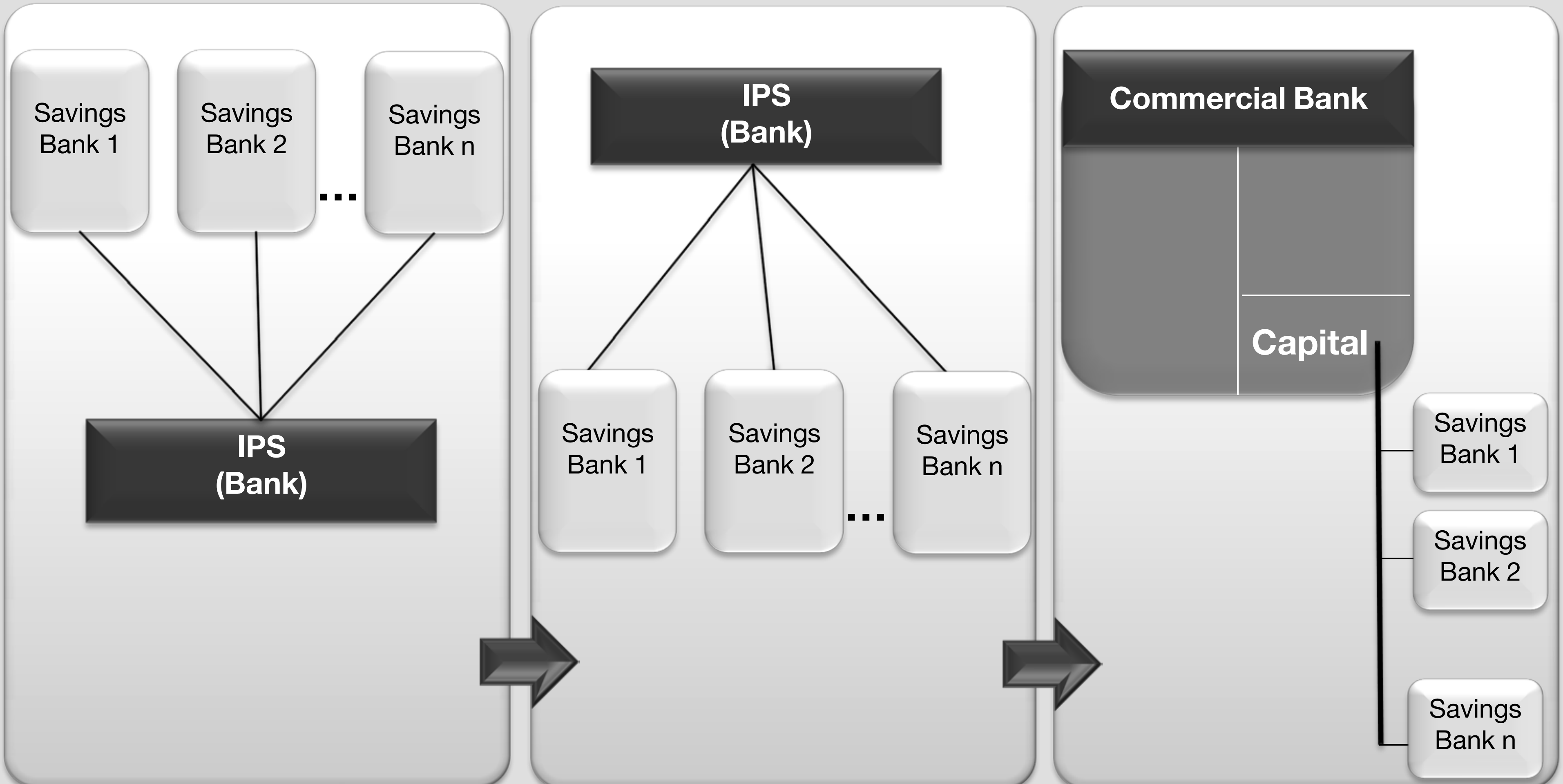
  - Savings banks become mere holders of a stake in the bank

Impact of the crisis and measures adopted

Third period: new measures

New Royal Decree-Law (5)

➢ **Deepening and simplification of restructuring process**

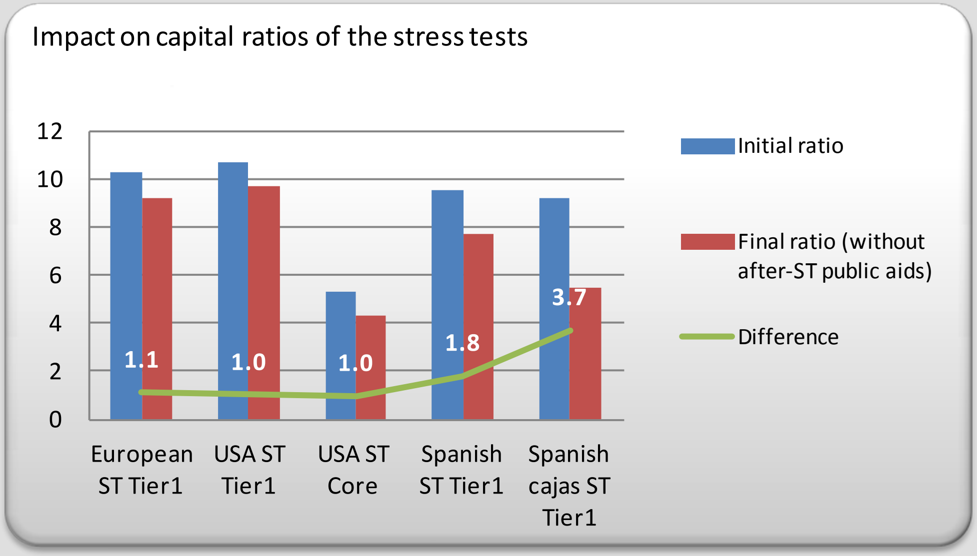


Impact of the crisis and measures adopted
Third period: new measures
New Royal Decree-Law (6)

- **How high are the new capital ratios?**

  - The Royal Decree-Law does not set a new stress exercise, but raises the ratio with which institutions must operate: it is a purely arithmetical exercise

  - By way of illustration, the stress tests in the United States, in Europe and in Spain entailed reductions in starting capital ratios which, if applied "directly" to the core ratio Spanish institutions have to maintain, would still leave Spanish banks with a comfortable capital cushion



Third period: new measures

New Royal Decree-Law (7)

- **The recently approved Royal Decree-Law entails an increase in the core capital ratio to 8%, and to 10% for those credit institutions** that evidence greater dependence on wholesale funding and which have not placed an amount equal to or greater than 20% of their share capital or voting equity with third parties

  - **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%)**

  - **Moreover, this bolstering of solvency comes after**

    – ***Institutions have made provisions equivalent to nearly a 9% of GDP and have increased their 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 the valuation of collateral (applying severe haircuts) and those that have to be set aside in the case of 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 stress tests*

Next steps

- **Following the approval of the Royal Decree, the next steps are**

  - **From its entry into force:**

    – ***To all intents and purposes, as from the approval of the Royal Decree-law, and insofar as the FROB acts as a backstop, Spanish credit institutions will operate with a core capital ratio of 8%-10%***

  - **In March:**

    – ***Banks will be told in the first fortnight of March if they meet the new capital requirements established in the Royal Decree-Law, or whether they need additional capital to reach the minimum of 8% or 10%***

    – ***Those banks that do not see increasing their capital on the market as feasible will apply to the FROB***

    – ***Those others that do consider it feasible will, following approval by the Banco de España, have until September to comply***

  - **In September:**

    –***Where necessary, the FROB will provide the funds constituting 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***

Next steps

- **Having to apply to the FROB involves several consequences for banks**
  - The **FROB** will acquire **ordinary shares**, or other convertible securities, in such banks
  - 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 on the governing body of the bank issuing shares. It is not an intervention of the institution, but to be sure that recapitalisation plans involving public funds are fulfil by institutions**
  - 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

Conclusions

- The results of the restructuring and write-downs made to date have been substantial

- The new measures adopted are aimed at dispelling any remaining doubts about the soundness of the Spanish banking sector, …

- … whose future outlook, like that of the Spanish economy, cannot be derived in a linear fashion from the current situation

    - **The Spanish economy, as the IMF projections show, has capacity to grow**

    - **And the core business of Spanish banks is profitable in the medium and long term**