

# The Spanish banking sector: outlook and perspectives (December 2010)

# CONTENTS



- **The Spanish banking sector in perspective**
- **Outlook for the Spanish banking sector**
- **Measures taken by public authorities regarding the banking sector**
  - Revision of the impairment guidance
  - Stress tests
  - Update of the restructuring process of the savings banks
  - The reform of the savings banks law

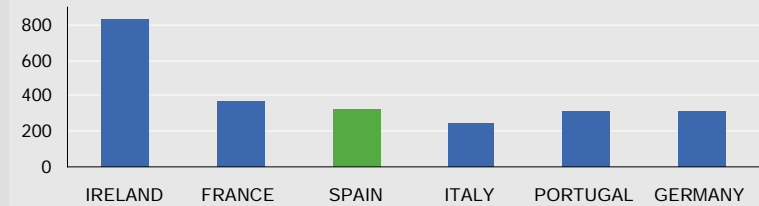


- **The European banking sector differs** across countries in terms of the **size of each national banking sector** relative to the economy ...

- ... as well as in terms of the **size of their major banking institutions**

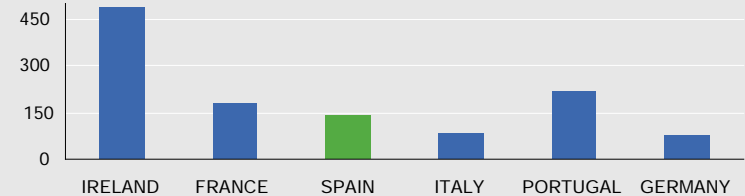
- **Differences across banking systems also exist regarding sectoral concentration**

Total banking assets as percentage of GDP. Dec. 2009



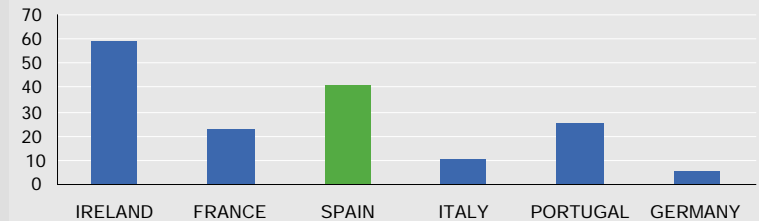
Source: ECB

Total banking assets of the five largest banks as percentage of GDP. Dec. 2009



Source: ECB

Credit to construction and property development as percentage of GDP. Dec. 2009



Source: ECB, National Central Banks and Banco de España

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# OUTLOOK FOR THE SPANISH BANKING SECTOR

## CREDIT



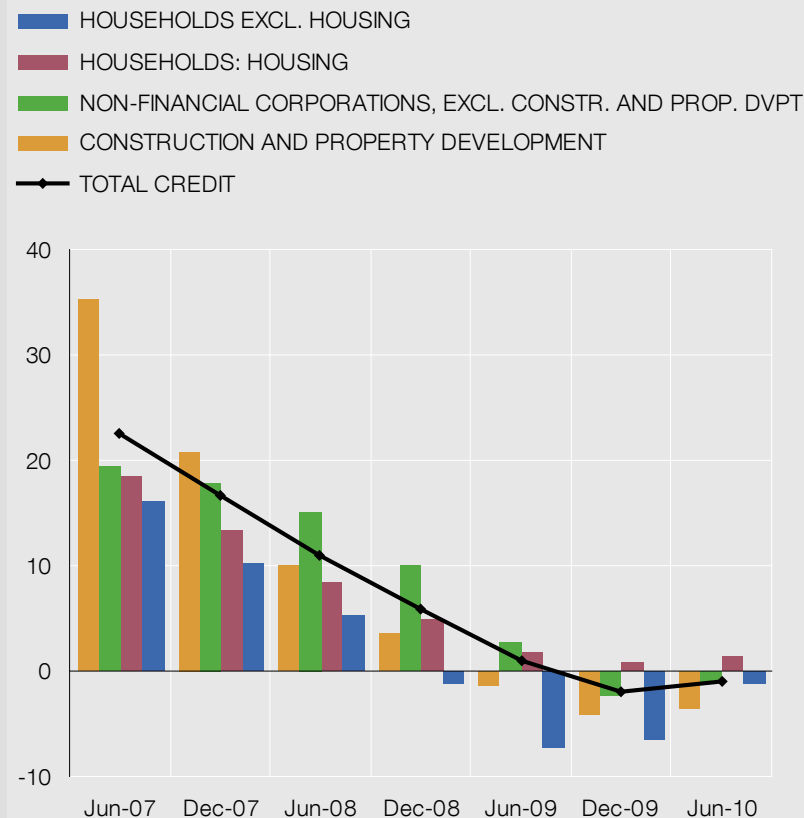
- **The downward trend of credit to the resident private sector has persisted**

- **The trend is more moderate in the last months**

- **This general trend is observed in the various sectors of activity, but to a different degree**

- **In any case, negative year-on-year changes of rate cannot be ruled out in coming months, which shows a natural adjustment process by the Spanish private sector**

Year-on-year rate of change in credit to the resident private sector, business in Spain, deposit institutions, %



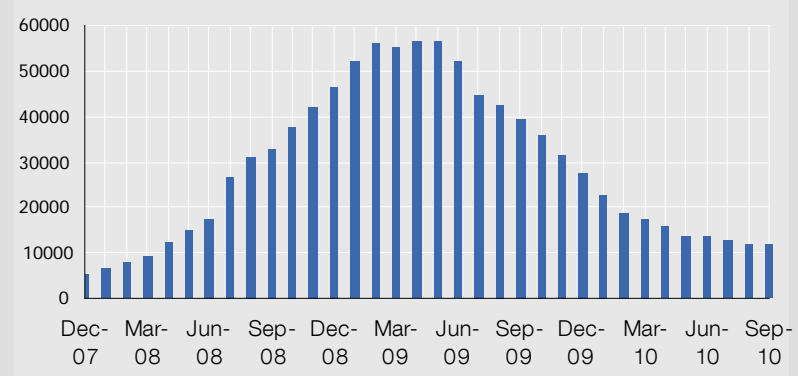
# OUTLOOK FOR THE SPANISH BANKING SECTOR

## DOUBTFUL LOANS



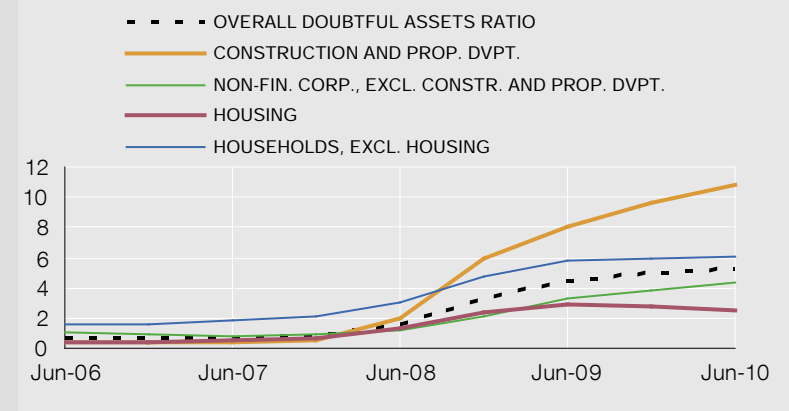
- **The year-on-year change in the volume of doubtful loans has gradually slowed down since mid-2009**
- **The slowdown in the formation of doubtful loans affects the doubtful loans ratio**

Year-on-year change in the doubtful loans of the resident private sector in Spain, deposit institutions, €m



- The doubtful loans ratio is higher in those sectors whose performance is most closely linked to the economic cycle,
- and it is particularly the case for the construction and real estate sector
- There are clear differences between credit granted to construction and property developers and retail residential mortgage credit

Doubtful loans ratios for credit to the resident private sector in Spain by sector of activity. Deposit institutions, %



# OUTLOOK FOR THE SPANISH BANKING SECTOR

## RETAIL RESIDENTIAL MORTGAGES



▪ **The credit for house purchase shows a low doubtful loans ratio: 2.5% in June 2010**

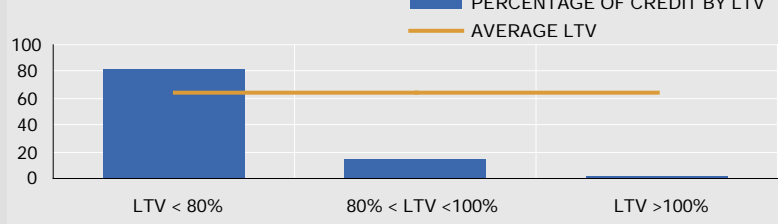
- A doubtful loans ratio of 2.5% is compatible with some securitizations and vintages for some institutions where the doubtful loans ratio is higher, probably because of higher LTV ratios

▪ **In any case, the average LTV ratio is 62% in the retail residential mortgage portfolio**

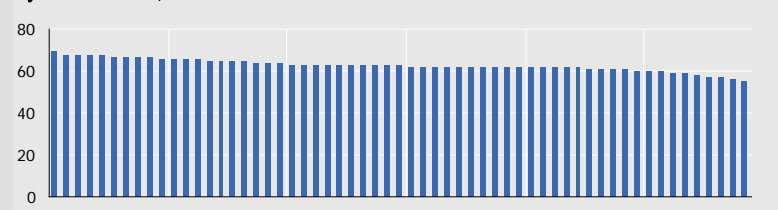
- This situation is quite homogeneous across deposit institutions

▪ **Stress tests show that the hypothetical losses in the extreme scenario are considerably lower in this portfolio than in others, even considering substantial hypothetical falls in house prices**

Distribution of retail residential mortgage credit by LTV and average LTV, deposit institutions, %

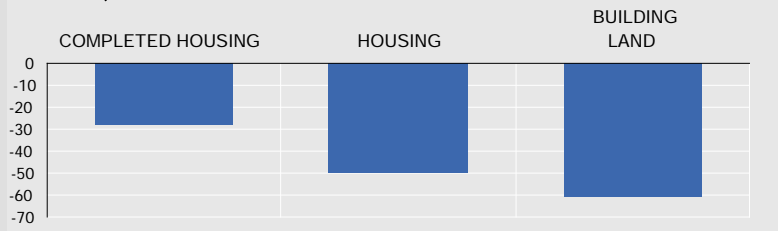


Distribution of average LTV of retail residential mortgage portfolio by institution, %



Note. The institutions represented account for 95% of total credit, and include all savings banks and major commercial banks

Collateral price fall assumptions in the stress test adverse scenario, %



# OUTLOOK FOR THE SPANISH BANKING SECTOR

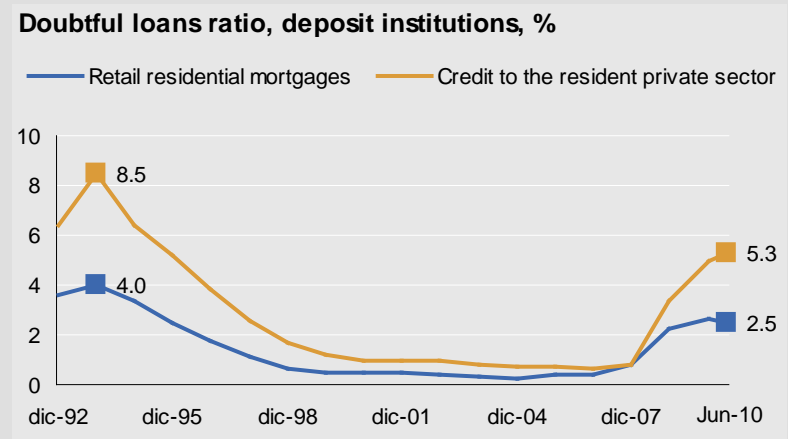
## RETAIL RESIDENTIAL MORTGAGES



- In Spain, lower doubtful loans ratios of credit for house purchase have already been observed in previous crisis (i.e., 1993)

- Retail residential mortgage business in Spain is plain vanilla

- No originate-to-distribute banking model, and thus no similar incentive problems when selecting and monitoring clients
- Buy-to-let business is practically non-existent
- No HELOCS (home equity line of credit)
- Mortgages are recourse



	Interest rate, housing market, %	Unemployment rate (b), %
<b>1993</b>	13.9	24
<b>2010 (a)</b>	2.6	20

(a) Latest available data  
 (b) There has been methodological changes along this period. Nevertheless the general message does not change





- The **construction and property development lending has a very pronounced cyclical profile. In June 2010 its doubtful loans ratio is 10.9%**
- To have a better understanding of the exposure of the banking sector to the construction and real estate sector, **Banco de España has defined and published a broader concept than doubtful loans**
  - **Doubtful loans**
    - *Loans in which some instalment has not been paid for a period of more than 90 days, and those exposures in which there are reasonable doubts as to total repayment under the terms agreed*
  - **Substandard loans**
    - *Loans showing some general weakness associated with the fact they are to a specific troubled group or sector or if weaknesses are apparent in certain operations, even if these operations do not qualify individually for classification as doubtful or write-off*
  - **Asset foreclosures, dation in payment and acquisitions**
    - *Assets ownership passes to the credit institutions, as a result of the application of these regular tools in a crisis situation such as the present. Supervisors prevent them from becoming potential mechanisms to defer the recognition of losses*
  - **Loan write-offs**

# OUTLOOK FOR THE SPANISH BANKING SECTOR CONSTRUCTION AND REAL ESTATE



- **The potential troubled exposure in June 2010 is €180.8 billion**
- **The level of coverage of this exposure through specific provisions is 26.6% and 33% including the generic provision related to the Spanish business of deposit institutions**

## BREAKDOWN OF POTENTIAL TROUBLED EXPOSURE AND THEIR COVERAGE. DEPOSIT INSTITUTIONS. JUNE 2010

	Amount €bn	% of investment	Specific provisions €bn	% coverage
Loans and receivables	439.0			
Doubtful	47.9	10.9	18.5	38.6
Sub-standard	57.6	13.1	7.8	13.5
Foreclosures and repossessions	70.0	15.9	16.6	23.7
Write-offs	5.3	1.2	5.3	100
Potencial troubled exposure	180.8	41.2	48.2	26.6
MEMORANDUM ITEM				
% coverage, including general provision				33.0

# OUTLOOK FOR THE SPANISH BANKING SECTOR FUNDING



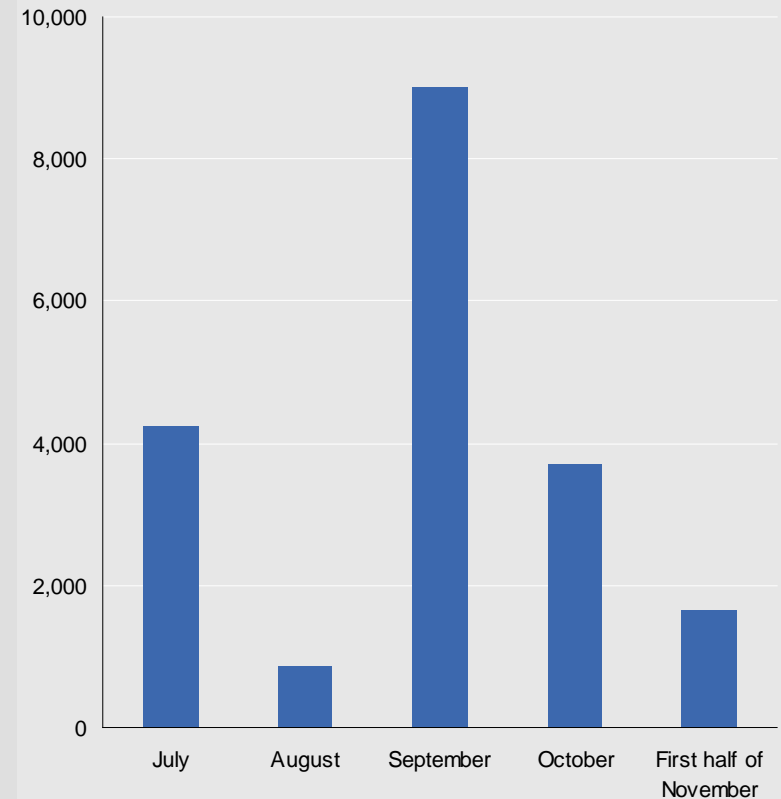
- **Since the end of July 2010 wholesale markets opened up again**

- Stress tests, approval of savings banks integration processes, reform of the savings banks law, fiscal consolidation measures and structural reforms help to explain the improvement

- **In the last weeks, market volatility has returned to the markets. Nevertheless:**

- Short-term markets are functioning with normality
- Several Spanish deposit institutions have been able to access primary markets
  - *Typically, since mid November, the activity in long-term wholesale markets is lower, and there are no major maturities in December*
  - *For these reasons, no major issuances are expected for the rest of the year*

Debt issuances of Spanish deposit institutions in the medium and long term wholesale markets, €m



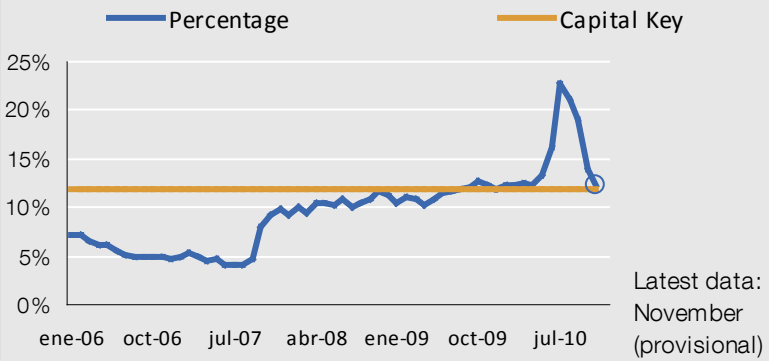
# OUTLOOK FOR THE SPANISH BANKING SECTOR

## FUNDING



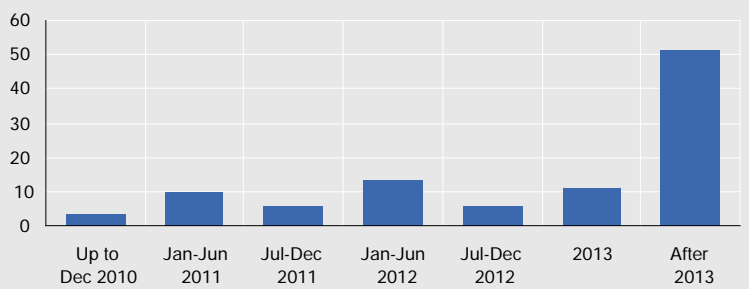
- As a result of the opening-up of wholesale markets, Spanish banks' use of Eurosystem liquidity has been significantly reduced

Eurosystem lending to resident Spanish institutions as % of total Eurosystem lending



- The majority of the maturities on medium and long-term debt is concentrated in the longer term. This alleviates refinancing needs

Maturity structure of outstanding medium and long-term debt (a), %



a. Not including assets securitisations because in the case of Spain they have no associated refinancing risk since maturities of the liabilities are linked to those of the securitised assets

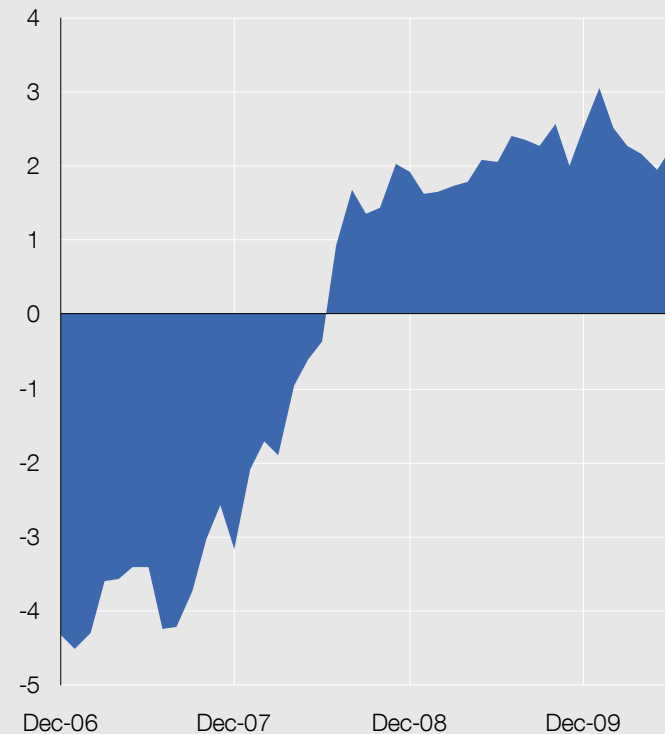
# OUTLOOK FOR THE SPANISH BANKING SECTOR

## FUNDING



- **Spanish institutions have continued to increase their retail deposit takings, but after several months of intense growth, year-on-year growth rates are now less intense than in the past**
- **The rise in the cost of wholesale funding has stepped up Spanish institutions' interest in raising new retail deposits, which, in turn, increases retail deposits interest rates**
  - Institutions pursuing these strategies should assess them on the basis of their strengths and profitability
  - To mitigate pressure on institutions margins, banks need to improve their operational efficiency
  - In the case of institutions that have received FROB funds, particular prudence is needed

Year-on-year change in deposit-to-credit ratio, credit and deposits of households and non-financial corporations, deposit institutions, %





- **Profit and loss accounts key drivers are**
  - **Provisioning requirements**
    - *Still have a negative impact despite the lower intensity in the growth of doubtful loans*
  - **Net interest margin**
    - *Increase in the cost of new deposits, and in the cost of wholesale funding*
  - **Banks are reducing their operating costs, which is a key element in this environment**
  
- **Improvement of solvency ratios, due to top quality own funds, while risk-weighted assets have slightly increased**
  - **Total solvency ratio in June 2010:** 11.8% (+10 bp versus June 2009)
  - **Tier 1 ratio in June 2010:** 9.6% (+60 bp versus June 2009)
  - **Core capital ratio in June 2010:** 8.0% (+50 bp versus June 2009)

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## ■ The content of the reform

- Simplification of the calendars in which coverage needs are based
- Treatment of collateral
- Treatment of repossessed assets

## ■ Simplification of the calendars

- The impairment estimation for homogeneous portfolios is based on calendars (i.e. it sets out the minimum provisions needed for non-performing loans). Now, the calendars have been unified (from 5 to 1), recognising impairment for the amounts not covered by collateral
  - *Until now, total coverage was reached after 2 or 6 years for high quality collateralised loans. Now, a total coverage is reached after 1 year taking into consideration the collateral posted on loans*

Up to 6 months	25%
Between 6 and 9 months	50%
Between 9 and 12 months	75%
More than 12 months	100%

- *However, specific haircuts are applied to the collateral ...*





## ■ Treatment of collateral

- The value of the loan that it is not covered by the collateral is treated in accordance with the proposed calendar
- The value of the collateral is recognised, considering the minimum value (cost or appraisal) is multiplied by a haircut
  - *Finished housing that is the borrower's habitual residence:* 20%
  - *Multi-owner offices, shops, and multi-purpose industrial buildings:* 30%
  - *Other finished housing (commercial residential real estate):* 40%
  - *Land lots and other real estate assets (commercial residential real estate):* 50%

## ■ Treatment of repossessed assets

- In the initial moment institutions must consider the minimum of
  - *The carrying amount (amortised cost of the assets less the specific provisions calculated using the proposed single calendar, and, in any event, a minimum of 10%) and the appraisal value of the assets, less the attendant sale costs, which, at a minimum, should be considered at 10%*
- *As a general rule, the required provision could increase to 20% or 30% if the time that the asset is maintained on the balance sheet more than 1 year, or 2 years, respectively*



- **The strategy** followed by Banco de España regarding stress test combines **toughness and transparency**
  
- **The objectives** were:
  - To explain the decisions and measures adopted by Banco de España
  
  - To disclose very detailed information in order to allow market participants to make their own assessments regarding the situation and the perspectives of the Spanish banking institutions
    - *By its nature, this information is still relevant in spite of being pass three months to assess the situation of the Spanish deposit institutions*
  
- **Toughness**
  - Double dip of the Spanish economy and significant price declines in collateral
    - 28% in finished houses,
    - 50% in unfinished houses,
    - more than 60% in land
  
  - Harsh assumption in net operating income



### ■ Transparency

- **Larger scope of the exercise in Spain**
  - *All listed commercial banks and all savings banks (around 90% of the assets of the Spanish banking system)*
- **Additional data published institution by institution regarding templates agreed at EU level**
  - *Portfolio breakdown*
  - *Provisions funds and tax impact*
  - *Dividends and fair value of mergers*
  - *Detailed information about external support received*

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

	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%				
<b>TOTAL</b>				

# MEASURES TAKEN BY AUTHORITIES

## UPDATE OF THE RESTRUCTURING PROCESS OF THE SAVINGS BANKS



- **The restructuring of the Spanish financial sector is focused on the savings banks, because some of these institutions were subject to a series of weaknesses accumulated during the prolonged period of growth of the Spanish economy**
- **The measures adopted respond to the orderly restructuring of the savings banks sector through integration processes**
  - Capacity in the system is considered excessive according to the probable evolution of the demand of financial services
  - The increase in bad loans and greater funding costs exerted pressure on institutions' profit and loss accounts. The generation of synergies is key
  - Savings banks face added difficulties in increasing their top quality capital through other means than retaining profits. This necessity explains the already approved changes regarding the legislation of savings banks

# MEASURES TAKEN BY AUTHORITIES

## UPDATE OF THE RESTRUCTURING PROCESS OF THE SAVINGS BANKS



- **Thus, this change in the structure of the savings banks sector has been channelled using integration processes that responds to a two-fold objectives: making institutions bigger and rationalising the sector's capacity**
  - The corporate integration processes conducted, increase the average size of the institutions, entailing economic benefits for the resulting groups by means of lower operating costs (through synergies), lower financial costs (higher size that facilitates the access to the wholesale markets), higher productivity, and more capacity to incorporate better management systems
  - The reduction in capacity is possible because integration plans includes reductions in terms of general, operational, and staff costs
  - The capitalisation of institutions is carried out more effectively and with less impact on public funds, inasmuch as the surplus or more abundant own funds at some of the participating institutions may offset, at least in part, those in a less comfortable position in terms of capital

# MEASURES TAKEN BY AUTHORITIES

## UPDATE OF THE RESTRUCTURING PROCESS OF THE SAVINGS BANKS



- **In order to facilitate this restructuring process, the Fund for the Orderly Restructuring of the Banking Sector (FROB) was set up on 26 June 2009.**
- **The FROB operates in two fronts. One, for crisis resolution at non-viable institutions. And the other, to support integration processes between viable institutions with a view of enhancing their efficiency in the medium term by strengthening their capital. The FROB follows some general principles**
  - It must look for solutions for individual credit institutions that minimise the cost for the public
  - Widespread recapitalisation plans are avoided by treating the problems of credit institutions individually
  - It promotes the accountability of shareholders and managers of the institutions subject to a restructuring process
  - The funds provided to credit institutions bear attendant costs (minimum annual remuneration of 7.75%); temporary (redeemable, in general, within five years); and conditional (subject to the presentation of a concrete merger plan that must be approved by Banco de España)

# MEASURES TAKEN BY AUTHORITIES

## UPDATE OF THE RESTRUCTURING PROCESS OF THE SAVINGS BANKS



- **The approved integration process means that the sector is now made up of 17 savings banks or groups of savings banks, instead of the former 45 existing institutions**
  - This reduction in the number of the savings banks is channelled through 13 integration processes. The institutions involved in this integration process account for 94% of the sector in terms of total assets
  - 8 out of 13 integration processes have received funds from the FROB for a total amount of €10,581 million
  - Before the year-end 2010, as a result of the integration processes, deposit institutions will constitute additional provisions against their total equity amounting to €26,200 million
  - On top of that, deposit institutions, regarding their business in Spain, have made very substantial write-downs since 2008 (until June 2010)
    - *47,024 million through their profit and loss accounts*
    - *plus €19,000 million against the previously accumulated funds due to the dynamic provisions in place since year 2000*

# MEASURES TAKEN BY AUTHORITIES

## UPDATE OF THE RESTRUCTURING PROCESS OF THE SAVINGS BANKS



- **To assess the calendar of the integration process is necessary to consider three major steps**
  - Legal and administrative changes, including the creation of the commercial banks that will act as the central institution in the institutional protection schemes.
    - *In all cases this stage is very advanced and it will be finalised by 31 December 2010 at the latest*
  - Corporate governance and management
    - *This stage is also in a very advanced stage, and it will be completed by 31 December 2010 at the latest*
  - Operational integration
    - *Institutions are working on this stage since the approval of the integration process, and in many areas plans are very advanced (i.e. IT platforms; central management and control of the economic and financial budget; central management of liquidity, risks and commercial activity)*
- **Banco de España supervisory teams are closely monitoring these plans**





- **The reform has three main features**
  - It gives savings banks the power to issue capital instruments that may be included in core capital, thereby facilitating their access to capital markets
  - It contributes to the professionalisation of savings banks management and governing bodies
  - It subjects savings banks to effective market discipline
- **To attain these objectives the reform considers two mechanisms**
  - The creation of equity units with voting rights
  - The adoption of new business models



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