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**The challenges to the Spanish banking system in the face of the global crisis**

50th anniversary of ESADE

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I have the pleasure of celebrating today with you the 50th anniversary of this institution. Over this half-century, ESADE has earned a reputation as one of the most prestigious business schools in the world. Education and training is the most important factor driving economic and social development. I therefore wish to begin by congratulating you on the work you have done and encouraging you to continue on this path.

The crisis besetting the international financial system will henceforth be a mandatory topic of study in your classrooms. The events unfolding continuously since August 2007, and with particular virulence since September this year, make the current crisis the most serious one in living memory.

This crisis, like others before it, manifested itself as a loss of confidence by the agents participating in the financial markets. Nevertheless, there are features which make it different: its degree of complexity, its global span and the speed with which the problems spread from one financial system to another are unprecedented.

The current situation is further complicated by the notable weakness of the global economy. In these circumstances, the interrelatedness of financial and economic factors further contributes to the deterioration of the situation.

In the face of this exceptional conjuncture, the monetary authorities and the governments of the main developed economies have acted in coordination to adopt a set of far-reaching measures commensurate with the scale of the financial crisis facing us. Although we cannot expect that these measures will immediately correct the difficult economic situation at hand, but rather that the process of adjustment will be slow and laborious, they should however help financial institutions to resume normal operations and restore confidence to the financial markets.

How does this exceptionally difficult situation affect the Spanish banking system? What means are available to those of us in Spain who, in our different areas of responsibility, participate in the financial system? During my talk I will try to answer these two questions, but allow me first to dedicate a few minutes to clarifying where Spain stands in the difficult situation besetting the international financial system.

### **International context**

The financial crisis under way from summer 2007 to date can be divided into three phases.

The first phase ran from August 2007 to the beginning of last September and was characterised by the impact of the financial turmoil on the balance sheet and income statements of numerous financial institutions at international level. This turmoil originated in the subprime mortgage segment, although it progressively spread to lower-risk financial statements.

One of the business segments which had grown up in the US mortgage market was characterised by the extension of mortgages to individuals or households with scant ability to meet their payment commitments. These are known as subprime or high-risk mortgages.

Also, the process of transformation and securitisation of subprime loans consisted not only of packaging them and transforming them into bonds; in addition, the asset-backed securities issued were sliced into smaller portions and re-packaged, so the instruments purchased by investors were increasingly complex and opaque and it was very difficult to ascertain their true level of risk despite the excellent credit ratings generally awarded to them by rating agencies.

Numerous US and European banks were among those investors. Moreover, they invested in the securities via transactions recorded off their balance sheets through investment vehicles (conduits and SIVs) which enjoyed a regulatory treatment in terms of capital requirements that was much laxer than if they had been consolidated on bank balance sheets. These long-term investments were financed at very short-term through the issuance of securities targeted at money market investment funds or large non-financial corporations, which used them to put their temporary cash surpluses to work.

The house price slump in the United States and the marked worsening of defaults on subprime lending, particularly on the loans extended in 2005 and 2006, sowed doubts among investors, which began to ask about the level of risk of the AAA-rated bonds they had bought and which offered higher returns than those on government debt. The complexity of the products made it difficult to determine their actual ultimate exposure to the US subprime segment. In these circumstances, both money market investment funds and non-financial corporations withdrew from the market. The investment vehicles created to transfer the risk and keep it off bank balance sheets then saw their liquidity dry up and had to turn to the lines of credit committed by their sponsoring banks. This increased the amounts which banks had to borrow and forced them to turn to the central banks for financing from 9 August 2007.

The tensions which characterised thereafter the functioning of the interbank and credit markets, despite attempts by the monetary authorities to restore normality, were symptomatic of a growing lack of confidence about the situation of financial institutions in the main developed economies. These misgivings were confirmed by the considerable losses of banks caused by these complex

products linked to US subprime loans, which in many cases gave rise to the need to raise large amounts of capital.

Nonetheless, although some credit institutions went bankrupt as a result of those investments and others were rescued, no systemic institution went under. Indeed, the rescue of Bear Stearns in March, with the US authorities supporting its acquisition by JP Morgan, sent a message that such failures would not be permitted. In that long year, the credit and interbank markets functioned with difficulty and liquidity disappeared from the primary and secondary securitisation market, against a background of growing lack of confidence and aversion to risk. This enormously hindered the wholesale funding of credit institutions.

From last September the financial turmoil worsened and entered a second phase (intense crisis), the onset of which was marked by certain systemic events, each individually of notable size. Practically all the key financial markets were blocked, and this hit financial institutions hard. The harshness of the situation is evident from a look at the swathe of events which took place in less than two months:

- As a prelude, at the beginning of September the mortgage finance firms, Freddie Mac and Fannie Mae, which accounted for 50% of US mortgage lending, finally had to be bailed out by the Treasury.
- However, the bankruptcy of Lehman Brothers, the largest in the history of the United States, proved to be a turning point, precipitating a series of extremely serious bouts of financial instability. The background to this bankruptcy was that institutional investors had begun to withdraw large sums of money from investment banks, a phenomenon that led to the virtual disappearance of these banks in the course of a few short weeks in September. Merrill Lynch was acquired by Bank of America, while Goldman Sachs and Morgan Stanley became commercial banks.

At almost exactly the same time as the Lehman bankruptcy, the financial strains were evident in an extremely serious form in the insurance industry, which had already been under considerable pressure on account of the deterioration in highly rated financial products to which it was severely exposed. AIG (American International Group), one of the world's largest insurers and the biggest in the United States, was rescued and, to all intents and purposes, acquired by the Federal Reserve, in an operation without precedent in the United States or the rest of the world.

- The collapse of Lehman Brothers led to loss of confidence and a standstill in numerous markets, including some that had until then been functioning reasonably well and that

are fundamental to financing in the United States. Among these, the deterioration in the commercial paper market was particularly serious. After the Lehman Brothers bankruptcy, some money market funds with exposure to its debt recorded losses, causing investors to redeem their holdings. The funds were forced to sell large amounts of securities to pay investors, causing the market for the commercial paper of non-financial firms to be seriously damaged too.

- In Europe, investors were sceptical about the liquidity position of entities reliant on very short-term financing, subjecting them to fierce selling pressure on the securities markets. In the United Kingdom, what started as a problem for the largest mortgage lender (HBOS), which had to be bailed out by Lloyds TSB, spread to the whole banking sector, prompting the British government to launch an unprecedented intervention plan.
- The Belgian, Netherlands and Luxembourg authorities intervened in response to the problems at Fortis, a bank whose share price had collapsed, and the Belgian, Luxembourg and French authorities had to take action to deal with the problems at Dexia.
- The Icelandic government nationalised its three largest banks.
- In Germany the problems besetting the Hypo Real Estate bank led the government to design a rescue plan for the entity, at the end of September, and they are currently providing support to Bayern LB.
- In the Netherlands, the problems at ING required a large injection of capital from the government, and the French government also had to recapitalise France's five main banks.

In recent weeks the crisis has spread to many emerging countries, against a background of heightened risk aversion and the liquidation by investors of market positions subject to even minimal risk. The countries that have suffered most are those with significant current account deficits and financial systems strongly dependent on external financing. In Europe, I should mention Hungary, the Baltic States, Bulgaria, Rumania, Turkey and Ukraine, as well as Russia, which has also been affected by the fall in oil prices; and in Asia, Pakistan. In Latin America, although the starting position was in many cases better, the impact has been significant, for various reasons, in Argentina, Brazil, Chile, Colombia, Mexico and Peru. This risk aversion and heightened uncertainty has also been strongly apparent in the foreign exchange markets, which

have seen a sharp rise in volatility and a strong appreciation of the yen and the dollar, the latest protagonists in an ongoing crisis.

In my opinion, we are now entering the third phase of the crisis, which banks are facing from different starting points, according to the extent to which they have been penalised in the first two phases. The basic characteristic of this phase will be the sharp slowdown in the most developed economies which will, in turn, be adversely affected by the global slowdown in lending. The recessionary tendencies are going to pose further problems for banks in the next few quarters although they will be more traditional, limited and familiar than those experienced so far.

The factors which have given rise to such a dismal outlook as that described are diverse and have all interacted with one another. Let me present them now, merely so as not to bore you, as a chain of errors committed by all the agents that have participated in the financial system.

To start with, the institutions that granted loans made mistakes, especially in the United States, where the originate-to-distribute model became widespread.

In the United States, in the years preceding the summer of 2007, lenders granted mortgage loans against collateral (real estate), whose value rose ever higher, generating incentives to lend to individuals with the lowest credit quality. This, combined with a business model in which the loans were packaged, turned into securities and sold on the market, meant that the incentive for lenders to correctly assess and subsequently monitor the risks was very low, since they did not retain the risks of the loan.

Not only were the advantages associated with a model of this kind – which allows the risk assumed by the institutions to be managed with greater flexibility – not correctly harnessed, but the model eventually gave rise to transactions in which institutions had no incentive to select borrowers correctly. They became mere intermediaries for the credit granted by the system, mere commission earners, interested solely in the volume of operations.

Many institutions also made mistakes in their management systems, such as their staff remuneration arrangements. The remuneration of the managers of many institutions was linked to short-term profits, without any consideration of the levels of risk being assumed to obtain them.

Other banks, especially in central and northern Europe, made mistakes not so much in their lending as in their securities investments, using very unrealistic, or unjustifiably optimistic, risk assessments. In a context of abundant liquidity at the international level, many financial institutions sought higher profits by investing in this type of complex instrument associated with the subprime segment as a mechanism to compensate for the fact that lending margins were narrower than in

the past, relying excessively on the assessment of their credit quality by rating agencies. Another mistake made by many institutions, in an attempt to recover past levels of profitability, was to significantly increase their levels of leverage.

The rating agencies also made mistakes, of almost scandalous proportions. They surprised investors by downgrading some securities from triple AAA to junk bond status overnight.

In many countries, indeed, regulators and supervisors also made mistakes, failing to limit the perverse effects of the dynamics and incentives that I have just mentioned. The weak regulation to which some financial market participants were subject, an over-complacent view of financial innovation, which failed to identify those developments that had proven themselves incapable of contributing value to the economy, and the lax interpretation of the international accounting standards in relation to the need to consolidate off-balance-sheet vehicles like conduits and SIVs, are illustrative in this respect.

Finally, central banks have not been free from mistakes either. The long period of low interest rates in the United States and, albeit with some differences, in Europe and in the rest of the world too, led financial institutions, firms and households to become very highly leveraged. Although this stimulated economic growth, it also allowed the large imbalances that are now so starkly revealed to build up. This world-wide expansionary policy, the risks of which were clearly signalled by the BIS, has probably been the most important factor contributing to the present crisis. As a result, as soon as house prices began to fall in the United States and monetary policies became less expansionary in the face of the inflationary risks arising from commodity price rises, the credit expansion cycle was broken. That caused significant rises in default rates, which affected the securities that had been distributed on the market among large numbers of investors, and the crisis whose main events I have mentioned was triggered.

Having described the complex and extremely difficult international context, I now propose to offer some considerations regarding the situation of the Spanish banking system, by answering two questions. What has happened in Spain during these fifteen months of financial crisis? And what is going to happen in the near future?

### **What has happened in Spain?**

The answer as to what has happened in Spain during the crisis is, as we all know, that nothing has happened remotely comparable to the succession of bank bankruptcies and bail-outs seen in the United States and practically throughout Europe. And this despite the fact that, at the beginning of the crisis, many international analysts identified the Spanish banking system as that which would

suffer the greatest problems on account of its need for external financing, its dependence on wholesale markets and the degree of its exposure to the property market.

To try to explain why Spanish institutions have passed the tough test posed by this unprecedented crisis, I shall use the phrase recently used by Jacob Frenkel to summarise, humorously and clearly, the problems currently affecting many American and European banks. What has happened, according to Jacob, is that in the balance sheets of these institutions “on the right side there’s nothing left, and on the left side there’s nothing right”. In other words, on the assets side everything is damaged, while on the liabilities side, because some banks have financed themselves at such short maturities, the financing has vanished into thin air.

This simplification of reality is highly illustrative of the situation that many international banks have got themselves into, but it also explains why the Spanish banking system has escaped the crisis.

On the liabilities side, things are different in the Spanish banking sector. Admittedly, Spanish banks have been very active in seeking financing on the international wholesale markets. But they have focused on the longer maturities. This has given them greater peace of mind with regard to the structure of their liabilities, despite the fact that the cost has been higher than it would have been if they had made more use of financing at the shortest maturities.

Spanish banks’ recourse to wholesale markets has taken the form of various instruments, including asset-backed securities. However, Spanish securitisation bears little resemblance to that which is currently proving highly problematic. First, because of the high quality of the securitised portfolios. And second, because securitisation was not conceived of as a business in itself to transfer risk. Rather, simple transparent structures were created to raise financing. This, along with the prudential regulation and supervision applied in Spain, has meant that banks did not establish complex off-balance-sheet structures (conduits and SIVs) acting like parallel banks.

Continuing with the analysis of the liabilities, it should not be forgotten that Spanish banks have traditionally maintained a solid deposit base. This is largely explained by the particular banking model followed in Spain. Activity is focused on retail business, with a proven capacity to adapt their combined offering of investment products. Spanish banks manage a large part of the assets of investment funds and sell insurance products. Evidence of this is the strong rate of growth of deposits in recent months, showing a notable response by banks.

Accordingly, Frenkel’s phrase does not apply to Spain on the liabilities side: there is still a lot left on the liabilities side of Spanish banks’ balance sheets, in particular a broad deposit base and a significant volume of wholesale financing that matures in the medium and long term.



If we now look at what is happening on the assets side, Spanish banks have not invested in the complex and opaque products that have turned out to be highly problematic or, as people usually now say, “toxic”. Admittedly, we are seeing a sharp rise in the doubtful assets ratio; however, this is not linked to this type of complex product, rather it is linked to developments in the real economy and therefore what may be called a classic banking cycle problem. Accordingly, on the left-hand side of the balance sheet there is still a lot right in Spain. Spanish banks’ assets, even taking into account the rise in doubtful assets, are largely of good quality.

The fact that Spanish banks’ assets are mostly high-quality and that they have a liabilities structure in line with the activity they finance, in terms of maturities and the degree of permanence, is related to their business model. In contrast to the originate-to-distribute model, the activity of Spanish banks is based mainly on attracting savings to lend to businesses and households and, in the process, maintaining close and lasting links with their customers.

This business model has normally been known as “traditional” banking, and many analysts prior to the summer of 2007 equated the concept of traditional with “antiquated”. True, just as the originate-to-distribute model has limitations, which have been laid bare, so too does traditional banking, insofar as it may indeed be antiquated in its management strategies and risk and cost control procedures. Consequently, it does not seem right to me to call Spanish banks “traditional”: Spanish banks bend over backwards for the customer, obtain information and management advantages from their detailed knowledge of their customers and have demonstrated their innovative capacity in the marketing of different products, in their risk control and management mechanisms, and in the application of organisational developments and technological processes, enabling the sector to become one of the world's most advanced and efficient.

### **What will happen to banks in Spain over the next few years?**

The road travelled so far has thus seen the entrenchment of a banking system with a proven capacity to manage risk and high levels of profitability, efficiency and solvency. This system has contributed decisively to the Spanish economy’s continuously strong growth since 1994 and has withstood the first two phases of the international financial crisis well.

At the onset of what I have called the third phase of the crisis, the sector is in a strong position. Moreover, the Banco de España has the ability and experience to resolve the most complex situations without damaging savers or the economy as a whole. However, although there is no sign of problems at Spanish banks in the short term, there is a temptation to which we bank supervisors must never succumb: complacency.

Thus, I feel obliged to conclude by identifying the challenges that the Spanish banking system is going to face and suggesting the action necessary to overcome them with the greatest guarantee of success.

The future challenges will arise, on one hand, from the international financial crisis, a phenomenon affecting all European banks; and, on the other, from the weak macroeconomic situation, which has global dimensions, but also elements particular to Spain. Both forces are going to affect the income statement, and therefore the ability to generate profits which, as we all know, are banks' first line of defence against future problems.

In the first place, banks are already suffering difficulties arising from the international financial crisis and, in particular, the consequences of the closure of financing markets. In this regard, the particular structure of the liabilities of Spanish banks, characterised by a broad deposit base and debt with mostly medium and long-term maturities, together with the plans recently approved by the Spanish parliament in coordination with other EU countries, mitigates the problem, but does not make it disappear.

The cost of financing will certainly not be the same as that prevailing prior to the summer of 2007, when investors began to rapidly reassess the risk of financial instruments. Even if the wholesale markets gradually re-open, it is highly unlikely that the differentials required by the various products will return to their exceptionally low pre-crisis levels.

Greater competition among banks to attract deposits, and the fact that they are replacing lower-remunerated sight deposits with time deposits, will also put pressure on the financial costs Spanish banks have to bear.

In short, the banking sector will have to live with a structure of higher financial costs, which will squeeze the net interest margin and, therefore, the capacity to generate revenues.

This situation, common to all financial institutions at the international level, may be partly relieved in Spain, insofar as a high percentage of the financing of Spanish institutions is granted at a variable rate, which allows them to adjust interest rates more rapidly to the general market risk premium, helping to keep their interest rate spreads more stable.

The second challenge is lower demand for credit both from households and businesses.

The lower demand for credit is a natural response to a weaker economic climate than in previous years. However, this response will be larger in the case of those economic agents who, after years of very notable growth in their indebtedness, have begun a process of financial deleverage.

For banks, this will mean a smaller volume of activity, that is to say, slower growth or even contraction of their business. In the past, banks responded to narrowing margins (income less financial costs) by increasing their volume of lending. However, this lever will not be available in the coming years, or at least not with the same strength, since lending can be expected to continue to decelerate, and to grow at below the economy's nominal growth rate.

Also, a smaller volume of activity puts further pressure on results, since overheads cannot be spread across a larger volume of activity. Accordingly, a commitment to rationalise costs must be a management priority for banks.

The third and final challenge that will exert even more pressure on banks' income statements in the coming quarters also arises from the weakness of the economic situation. Apart from the global deceleration, which primarily affects consumption and capital investment, we must not forget that the Spanish economy is in the midst of adjustment in the property sector. This adjustment had already begun, gradually, before the summer of 2007, bringing the sector progressively into line with the change in the determinants of residential investment. This gradual rate of adjustment was altered by the international financial crisis, which established a climate of mistrust and uncertainty which, in turn, intensified the slowdown.

The consequence for the banking sector has been a rapid growth in doubtful assets ratios since end-2007. This growth has been recorded across-the-board, but especially in construction and property development. Despite the counterweight provided by the existence of the general provision in Spain and the very low starting levels of the doubtful assets ratio, this has led to the need for greater credit write-downs, which have to be taken to the income statement, and that is the third reason why profits will be under pressure in the banking sector.

### **What must we do in this situation?**

Having reached this point, allow me some reflections on what we should do to address this situation. The first thing I should say is that the effort has to be shared, not only by monetary authorities and governments, but also notably by the institutions themselves.

The monetary authorities have, in recent months, mediated to a greater extent in the provision of liquidity to the financial system, also granting it at longer maturities and in other currencies, such as

the US dollar and Swiss Franc. The Eurosystem has firmly committed itself to strengthening this line of action, and has in fact undertaken to grant the liquidity that institutions may require, without limit as to the amount and at a fixed interest rate, provided that they have the appropriate collateral, the acceptable range of which has been significantly widened. Also, in an unprecedented action, the central banks of the main economic areas of the world took the joint decision to cut interest rates by 50 bp on 8 October. Admittedly, this reduction was not immediately passed through to market rates, owing to the crisis on the financial markets. But it is a measure that should be conducive to recovery in the confidence of consumers and businesses in the medium term.

For their part, governments have taken various decisions for coordinated action at the international level. The upshot is a set of measures characterised by their exceptional nature and forcefulness, since their objective has been to break the market standstill.

The proposal agreed by the European governments covers various areas. Thus, for financial institutions with insuperable solvency problems, it is proposed that the appropriate rescue solution be implemented. For other institutions, that are solvent, but in difficulties that make a strengthening of their capital advisable, many governments have made capital available to them through shares, or other debt instruments that are, for regulatory purposes, deemed to be capital, such as preference shares. Apart from capital strengthening, and in order that solvent institutions should start to function again as normal and have access once more to financial markets that have remained blocked, government guarantees are going to be granted for issues of bank debt. This latter line of action, i.e. that relating to the availability of liquidity and financing, has been supplemented in the case of Spain by the purchase of high-quality assets. Finally, and in order to boost the confidence of depositors, practically all countries have increased the amount covered by deposit guarantee schemes and have proposed reducing the period within which such deposits must, where necessary, be returned to depositors.

The Spanish government has prepared a roadmap that envisages all these actions. It will be implemented not so much to alleviate solvency problems, which have not materialised in our country, as to help restore confidence and facilitate institutions' access to financing. The ultimate aim is to avoid institutions' financing difficulties being the cause of a reduction in lending to firms and households. A credit slowdown stemming from the weakening of the cycle, due to its obvious effects both on the solvent demand for credit and on the risk-adjusted supply by institutions, would be another matter entirely.

For their part, institutions need to assume fully the new reality in which they will have to operate in the coming years and address it intelligently and decisively. This will require an adjustment of their

balance sheets, so that credit flows to the real economy while attention is paid to the greater risk of default which will have to be correctly managed. At the same time, on the liabilities side, it will be necessary to continue strengthening the deposit base as far as possible, since the capacity to finance banking activity through the wholesale markets will be more limited.

This adjustment of bank balance sheets must be accompanied by strict cost controls, which are the main mechanism for limiting the impact of the new environment on bank income statements. The economies of scale offered by bank consolidation (widely aired in the media) is one way to tackle this rationalisation of cost structures. In any event, irrespective of the strategy that each institution may decide to adopt, the result should be one of greater efficiency.

Finally, if we have to face a period of slower growth in banking activity, with greater uncertainty and lower profits, banks should also endeavour to strengthen their capital base. There are various ways of doing this, but in the scenario described, it seems logical to think of retaining more profits, without forgetting capital increases, or the issuance of non-voting equity stock by savings banks.

Allow me to conclude by repeating what I have already said on previous occasions. Governments, which have proven themselves resolute and decisive in the search for solutions to resolve the impact of the financial crisis on the economy, must also take action on the policies that directly affect the real economy.

In a country such as ours, integrated into the single monetary area and with its attendant competitiveness difficulties, decisive action is essential on structural reforms that liberalise product and factor markets, increasing competition and favouring a more efficient allocation of the available resources. Allow me to mention some of them, because it would be remiss of me to fail to speak today about what is most important for facing up to the crisis.

First, and given that the residential sector is subject to an especially intense degree of adjustment in the present situation, measures are needed that help to satisfy the demand for rented housing and that will also reactivate the demand for housing that is most closely linked to the investment motive. Liberalising the market for rented accommodation and giving legal certainty to owners would be one of the timeliest structural reforms.

Second, there are still a large number of sectors and market segments that should be liberalised in order to boost competitiveness. The distribution chains for goods and services provision, ports, airports, railway transport and energy are just a few examples.

Finally, I should like to mention the need to reform the labour market, collective bargaining and indexation clauses. In the absence of prompt and decisive reforms in these areas we will see unemployment increase sharply, with the harmful effects that this has on activity and on the stability of our financial institutions.

## **Conclusion**

We are currently facing an unprecedented international financial crisis in a severely weakened macroeconomic setting. Certainly our banking system has moved in the right direction, reinforcing its risk control management mechanisms, its profitability, its efficiency and its solvency. This gives it a solid starting position but we cannot allow ourselves to be either naive or complacent: the Spanish banking sector is facing major challenges that will affect its capacity to generate profits in the coming quarters.

I am convinced that our banks, which knew how to capitalise on the expansion, will also know how to take the appropriate management measures and adopt the right strategy to allow them to address these difficulties successfully. For our part, the public authorities will continue to take the measures necessary to ensure that this unavoidable adjustment takes place in the least traumatic way possible for our economy.

I believe that all of us, institutions and authorities, each from their own area of responsibility, are pushing in the right direction, and therefore I am convinced that we will successfully negotiate this extremely difficult time for the financial systems and economies of the main developed countries.

Thank you very much.