BANCO DE ESPAÑA
Eurosistema

SPANISH BANKING SECTOR: PAST, PRESENT AND FUTURE

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José María Roldán

Director General Banking Regulation
Banco de España

TAKEAWAYS OF THE PRESENTATION

- **The Spanish banking sector is sound**

- **Problems to be resolved are located in a small part of the Spanish banking sector, in particular in a group of savings banks**

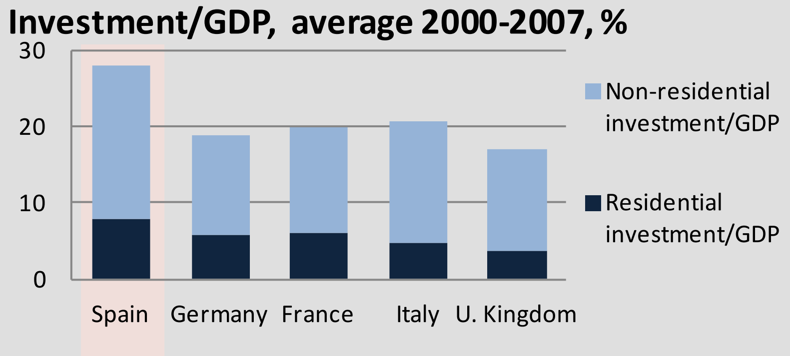
- **There is a clear strategy in place: capital injections are conditioned on restructuring**

- **Transparency is a key element of this strategy**

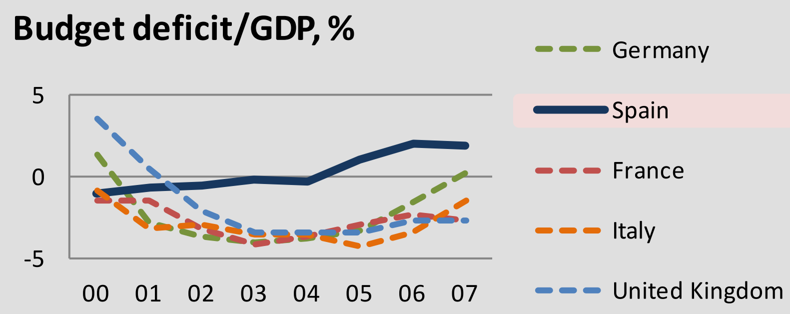
- **Most of the restructuring process has been already carried out, but we need to round it off**

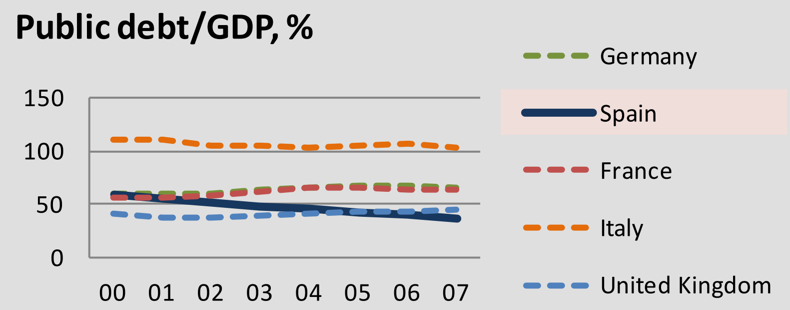
SPANISH ECONOMY. STRONG ECONOMIC EXPANSION BETWEEN 1994 AND 2007, ACCOMPANIED BY:

- **High levels of investment, only partly residential investment**



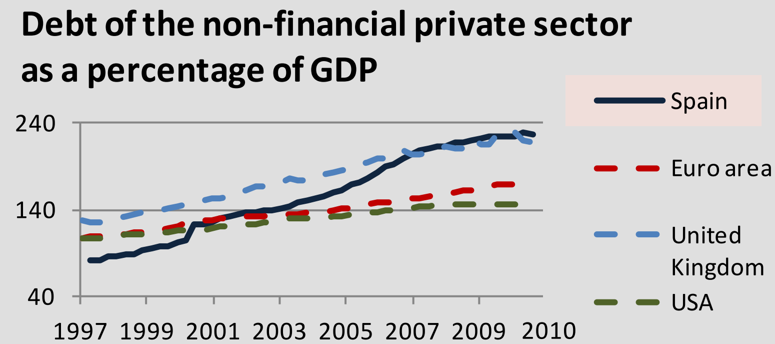
- **Budgetary equilibrium and low levels of public debt**



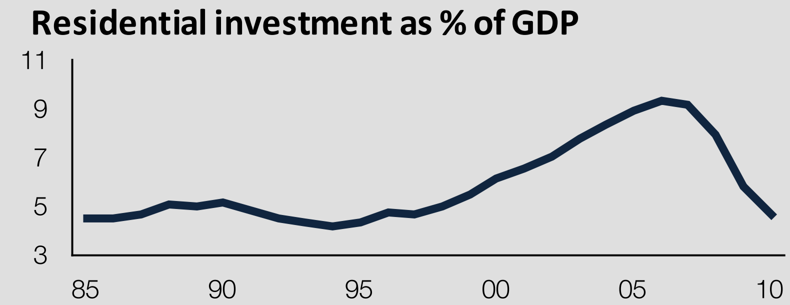


SPANISH ECONOMY. ECONOMIC GROWTH ALSO CREATED IMBALANCES:

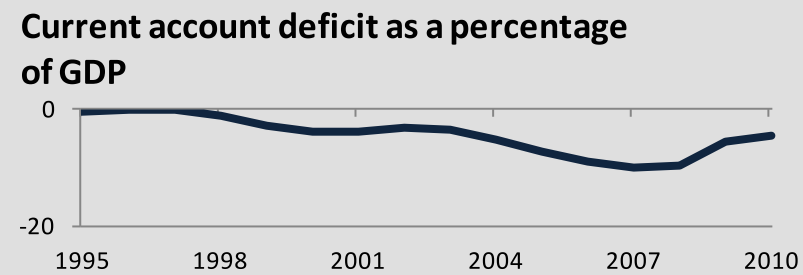
- Increasing indebtedness of the private sector



- Excessive increase of the housing sector

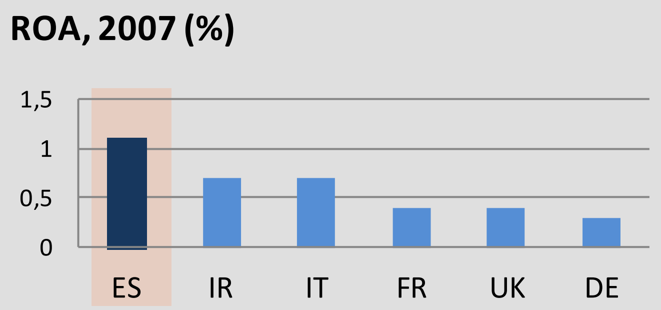


- Increasing current account deficit

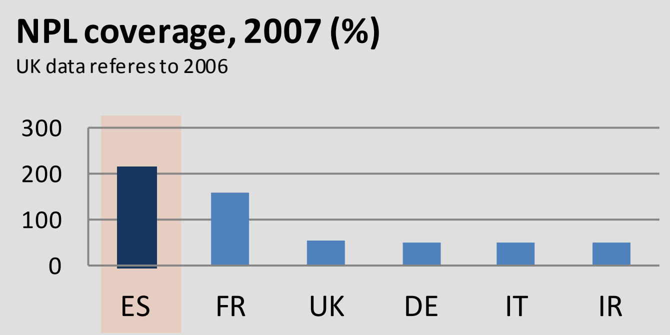


SPANISH BANKING SECTOR. GOOD STARTING POSITION BEFORE SUMMER 2007

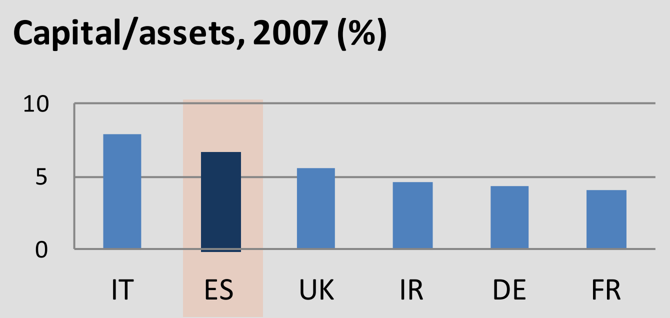
- Spanish banks pursue a traditional retail banking model …

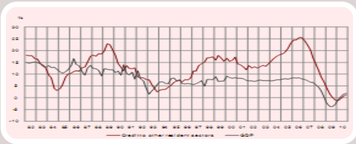


- compatible with sector's good starting position in terms of profitability, efficiency and solvency …



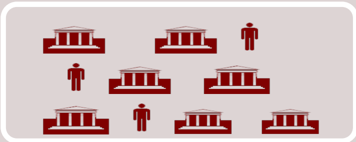
- and also with a prudent approach to wholesale funding





Sharp growth in credit

- Particularly in the construction and real estate developers sector



Overcapacity

- Observed in the excessive increase in the number of branches

Excessive fragmentation

- 45 savings banks

Lack of clear ownership of savings banks

- Weak governance
- Inability to raise top capital from the markets

Strategy

Recapitalisation conditional on restructuring …

… considering the three crisis occurred since summer 2007

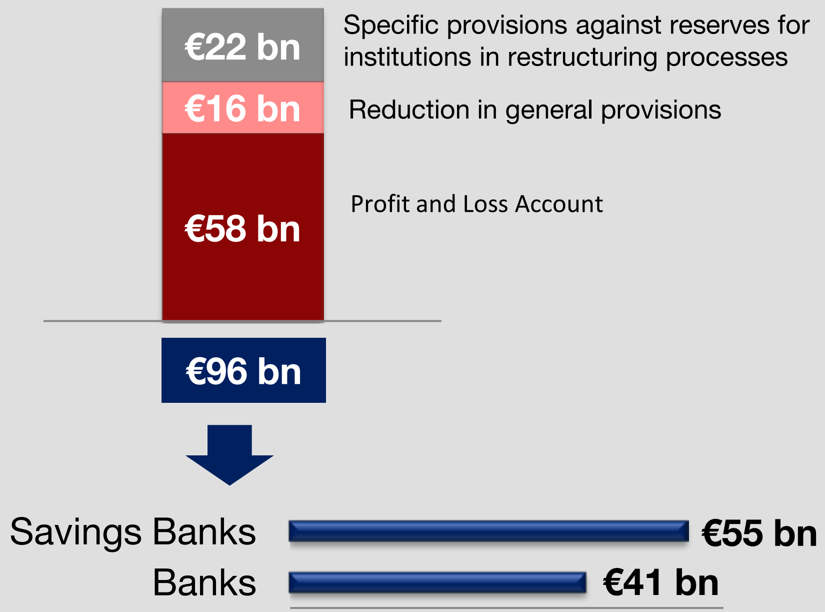
SPANISH BANKING SECTOR. SECUENCING OF THE MEASURES ADOPTED

	First crisis 2007-2008 International Financial Crisis	Second crisis 2009 Economic downturn	Third crisis Sovereign debt crisis: Greece 1st round - May 2010	Third crisis Sovereign debt crisis: Ireland 2nd round - Nov. 2010
PROBLEMS	• **Resilience** • **Indirect impact**: wholesale funding difficulties	• **Asset impairments** • **Overcapacity** • **Some SBs**	• Doubts over the sustainability of **Greek public finances** • Impact on investors confidence	• **Economic weakness persists** and **bank potential losses related to the real estate sector in Ireland** puts additional **pressure on public debt**
MEASURES	✓ Granting of **guarantees for banks issuances** ✓ **The Eurosystem** approves to **meet all the demands for liquidity**	✓ **FROB**	✓ **Stress testing** ✓Tightening of **provisions** ✓ Reform of **savings banks legislation**	✓ **More transparency** ✓ **Increase in capital requirements**

SPANISH BANKING SECTOR. BALANCE SHEET CLEAN-UP EQUIVALENT TO A 9% OF GDP

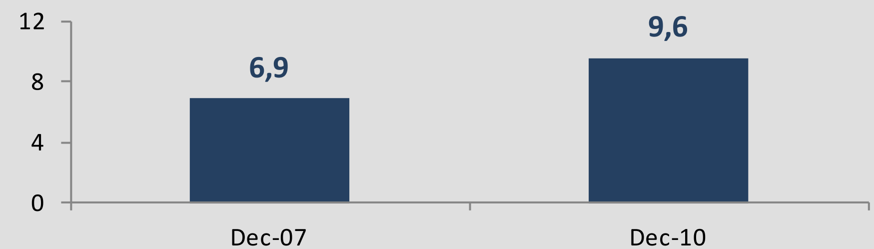
- **Since January 2008 the banking sector has recognised and assumed asset impairment losses for an amount of €96bn**

Already consolidated provisions



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

Tier 1 Capital (%), deposit institutions



SPANISH BANKING SECTOR. REFORM OF THE SAVINGS BANKS SECTOR

- **Integration processes: from 45 savings banks to 18**
  - **High execution risk** related to several integration process involving different institutions in each of them…
  - **… Ex-post very limited and controlled execution risk:** only one project, that was not completely closed at December 2010, failed

- **Reduction in capacity**
  - Branches: between 10%-25%; staff: between 12%-18%

- **Key changes in management**
  - **Replacement of former managers**
  - In mergers **the executives of the savings bank** that was **better managed are taking the leadership**

New regulation requires core capital of 8% - 10% (i.e. €16 bn for the savings banks)

Standalone savings banks

9 institutions

13% of total assets of the banking sector

Other savings banks

9 institutions (*)

First option: IPO and/or private investors

4 institutions

15% of total assets of the banking sector

→ **Short-term solution**

Fist option: FROB

4 institutions

8% of total assets of the banking sector

→ **Solution under way** (Temporarily: FROB)

The FROB acts as a backstop mechanism:

1. Common shares
2. Market valuation

(*) One institution first option is to participate in an integration process with a well capitalized institution

▪ **Different research reports show higher capital needs. Why?**

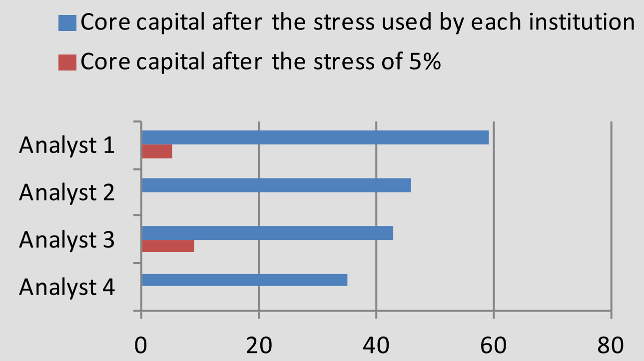
▪ **These reports are based on stress test: Are capital needs resulting from a stress test too much or too low? There are four elements needed to define a stress test**

1. Assumptions regarding the **adverse macroeconomic scenario**
2. **Hypothetical losses** arising from the adverse scenario
3. **Elements to absorb losses** (operating margin before provisions, already accumulated provisions, capital)
4. **Capital ratio that banks should hold after the stress (5% EBA ST; 4% US SCAP)**
   - *For Spanish deposit institutions each additional percentage point of core capital means €20 bn of additional capital*

SPANISH BANKING SECTOR. REFORM OF THE SAVINGS BANKS SECTOR - CAPITALISATION

- **Key difference vs. "average market capital needs estimates":**
  - **Market analysts core capital ratio after the stress: 8.5%-10%**
  - **EBA** core capital ratio after the stress: **5%** (**US SCAP was 4%**)
- **On top of that core capital targets after the stress, some analysts consider very extreme assumptions**
  - **Stress scenario** equal to around **1.7 times the expected losses of the July 2010 ST adverse scenario**
  - **Coverage ratios for doubtful assets = 100%,** which means not to consider the existence of collateral (LGD=100%)
  - **Severe hypothesis** on the **potential resources** to absorb potential losses

Capital requirements after the stress test, €bn. Different benchmark capital ratios



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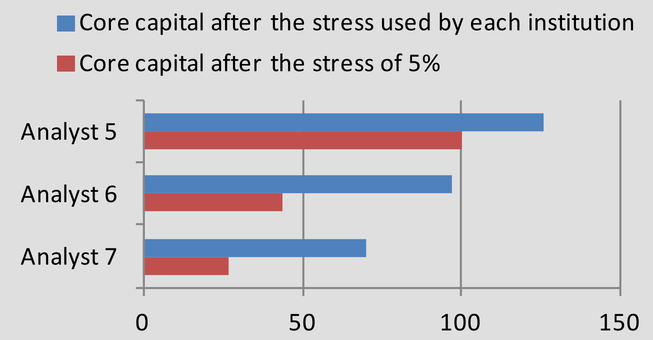
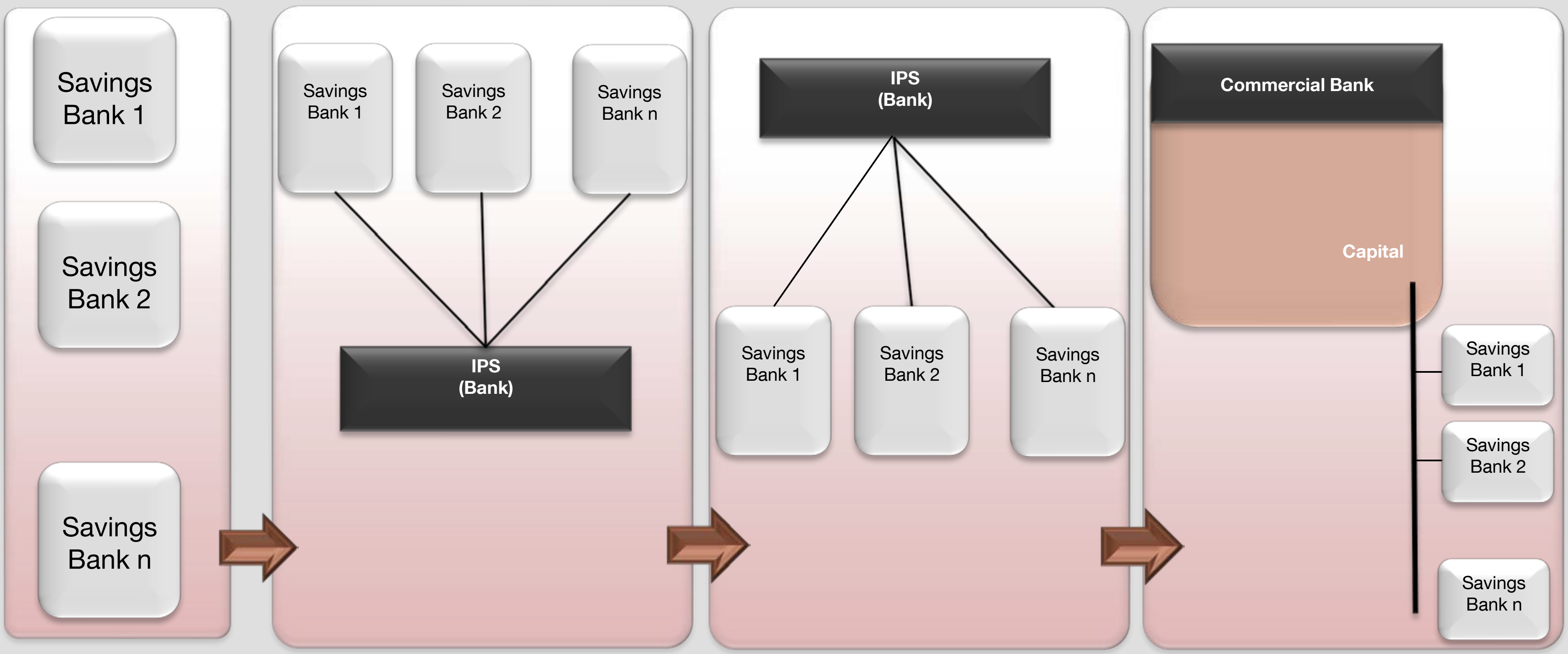
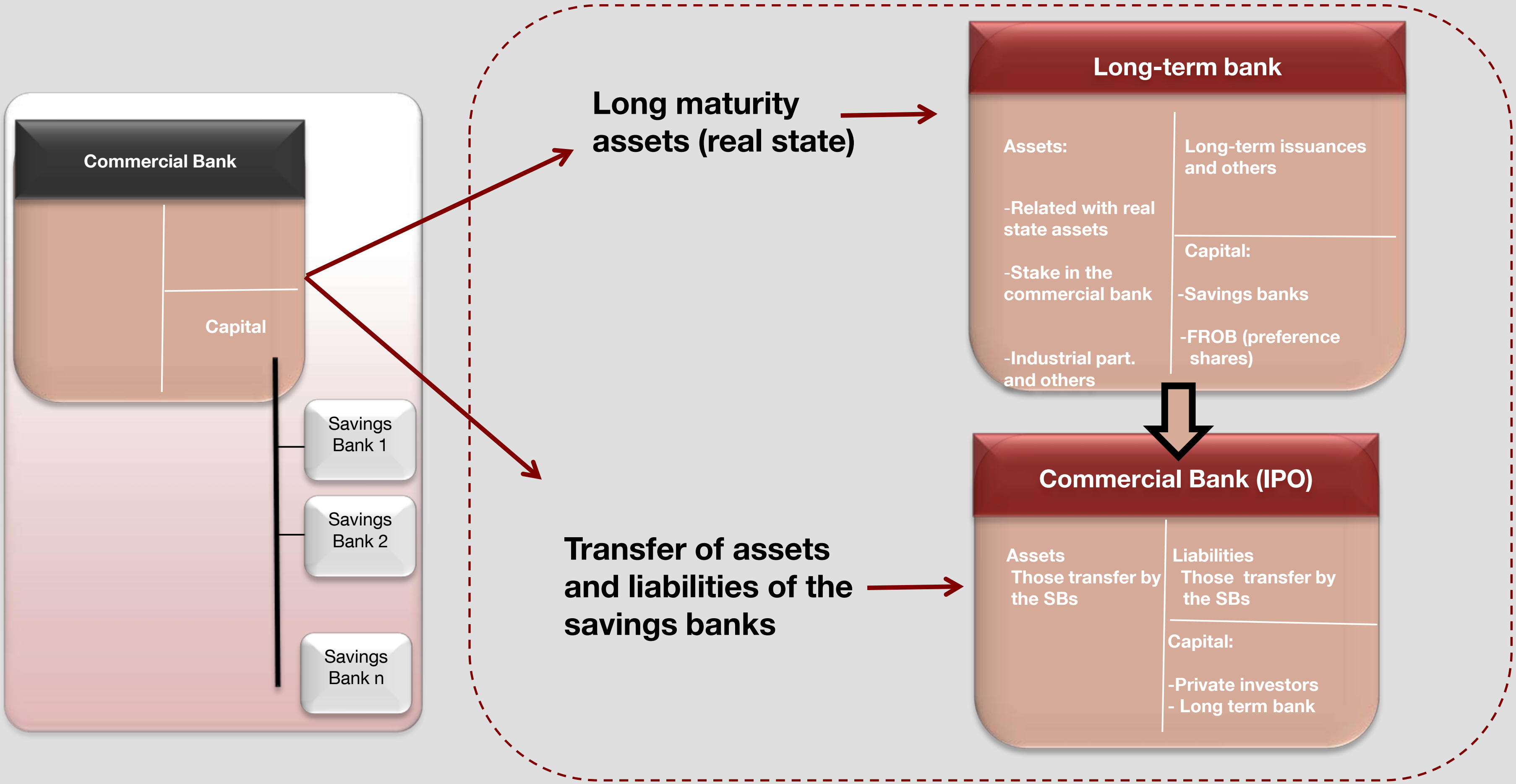


SPANISH BANKING SECTOR. REFORM OF THE SAVINGS BANKS SECTOR – TRANSFORMATION INTO BANKS …



SPANISH BANKING SECTOR. REFORM OF THE SAVINGS BANKS SECTOR – … TRANSFORMATION INTO BANKS



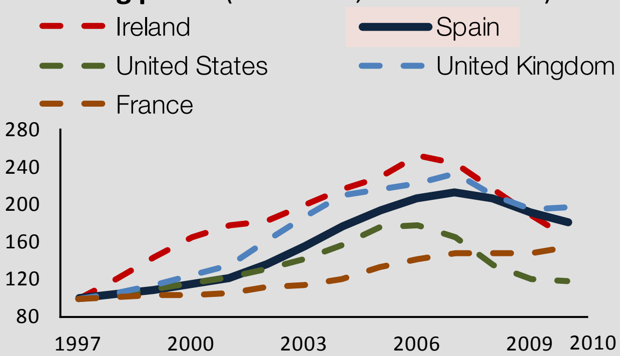
SPANISH BANKING SECTOR. ASSET VALUATION

Tightening in provisioning requirements in July 2010	✓Accelerate the coverage requirements (100% in 1 year) ✓Consideration of tougher haircuts in collateral values (i.e. 50% for land and building plots) ✓Requirement of provisions for foreclosed assets
Independent expert valuation (FROB)	✓Market valuation using standard methodologies ✓Valuation done by international audit firms and investment banks
Market valuation	✓For those institutions that are in the process of obtaining capital from the markets

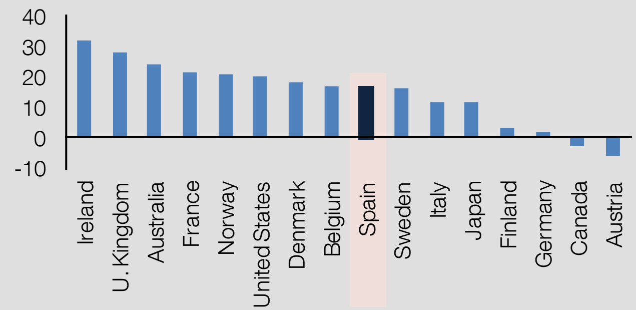
SPANISH BANKING SECTOR. HOUSING PRICES

- **House prices overvaluation ...**

Housing prices (real terms, Base 100=1987)

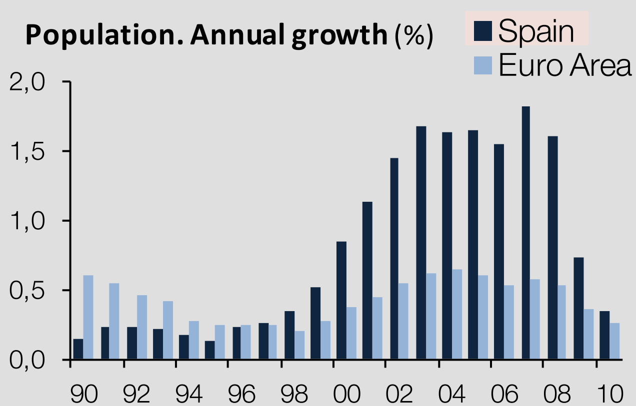


Percentage increase in house prices not attributable to fundamentals, IMF April 08

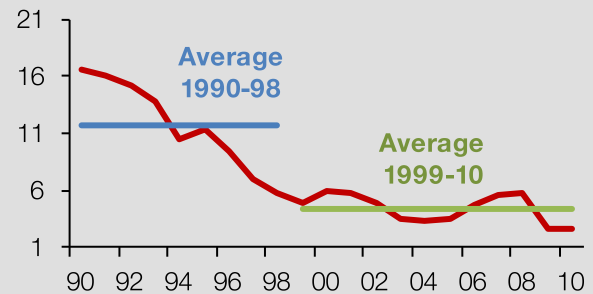


- **... has been favoured by demographic dynamism and low interest rates**

Population. Annual growth (%)



Interest rate on loans to households for house purchase, %. Spain

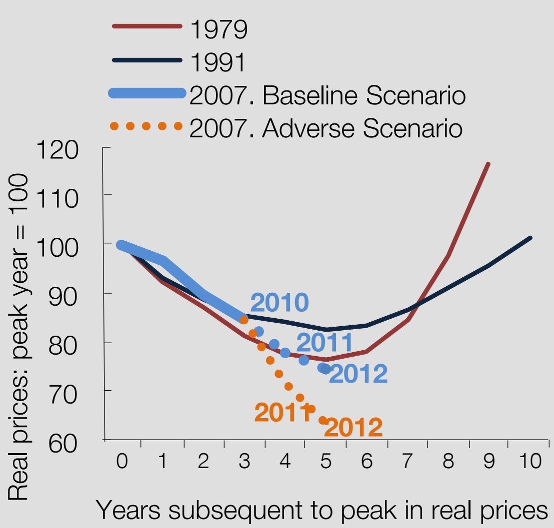


SPANISH BANKING SECTOR. HOUSING PRICES

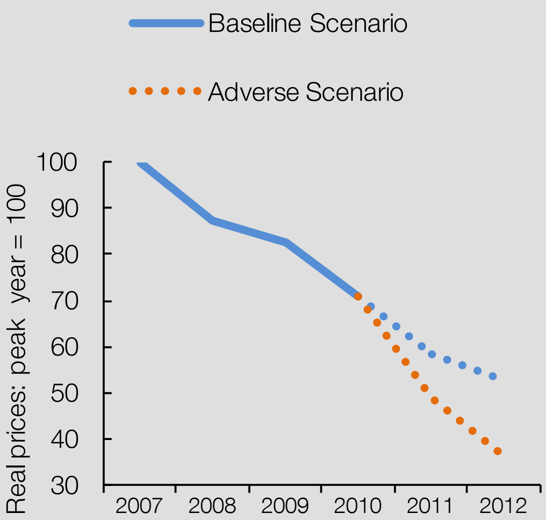
- **There has already been a correction in house and land prices. In both cases we expect further corrections in the year to come**

- **In any case, in ST exercises we are not using benign scenarios**

THE ADJUSTMENT OF HOUSING PRICES: COMPARISON BETWEEN THE CURRENT AND PREVIOUS CYCLES (In real terms)



THE ADJUSTMENT OF LAND PRICES: THE CURRENT CYCLE (In real terms)



CUMULATIVE ADJUSTMENTS IN EBA SCENARIOS FROM PEAKS TO 2012 (%):

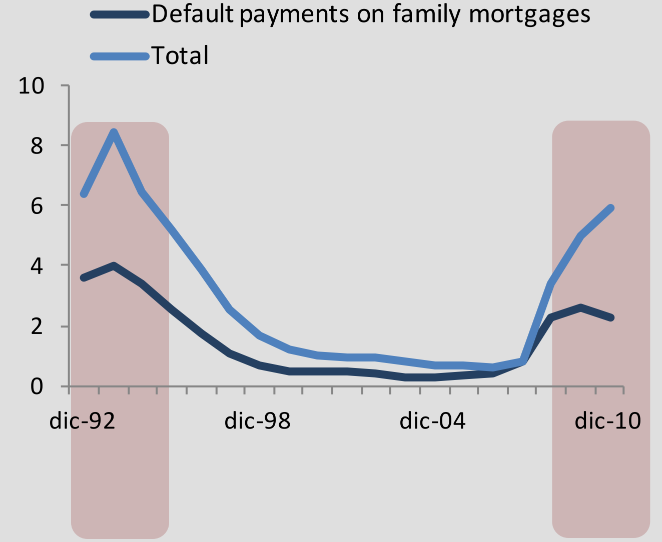
Baseline Scenario			
Housing		Land	
Nominal	*Real*	*Nominal*	*Real*
-17,7	-25,3	-42,1	-47,5

Adverse Scenario			
Housing		Land	
Nominal	*Real*	*Nominal*	*Real*
-30,1	-36,5	-60,1	-63,8

SPANISH BANKING SECTOR. RETAIL MORTGAGE PORTFOLIO

- **Retail mortgage market is not an issue**
  - NPL ratio in this portfolio has already been observed in other crisis, such as in 1993
  - The reason is that this business in Spain is plain vanilla
    - *- No originate-to-distribute banking model*
    - *- Buy-to-let business is practically non-existent*
    - *- No HELOCS*
    - *- Mortgages are recourse*
    - *- Socio-demographic reasons*

Private credit default rate, %
Deposit institutions



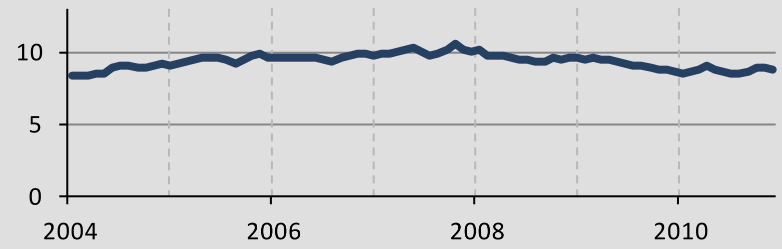
Unemployment	**24%**
Mortgage rate	**13.9%**

Unemployment	**21.3%**
Mortgage rate	**2.8%**

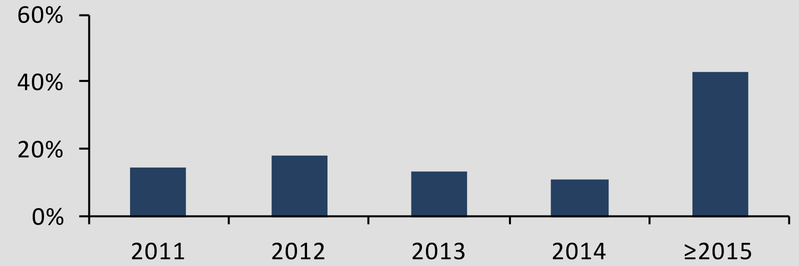
SPANISH BANKING SECTOR. FUNDING

- **In normal times, bank funding followed sound practices**
  - Banks have a preference for long-term funding
  - And with maturities distributed in an uniform manner
- **In stress times, banks had to adapt their funding**
  - Initially the increased the use of central bank liquidity, but progressively reduced it

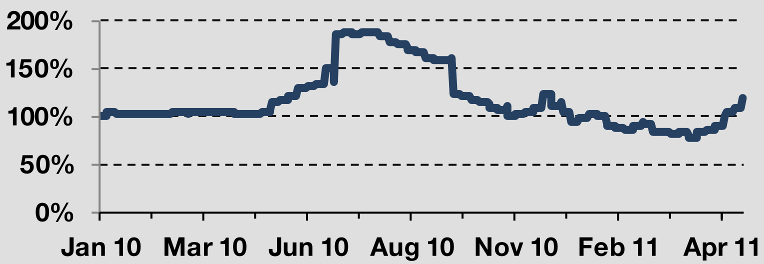
Outstanding issues. Average maturity (years)



Outstanding issues by date of matuty



Gross borrowing over capital key



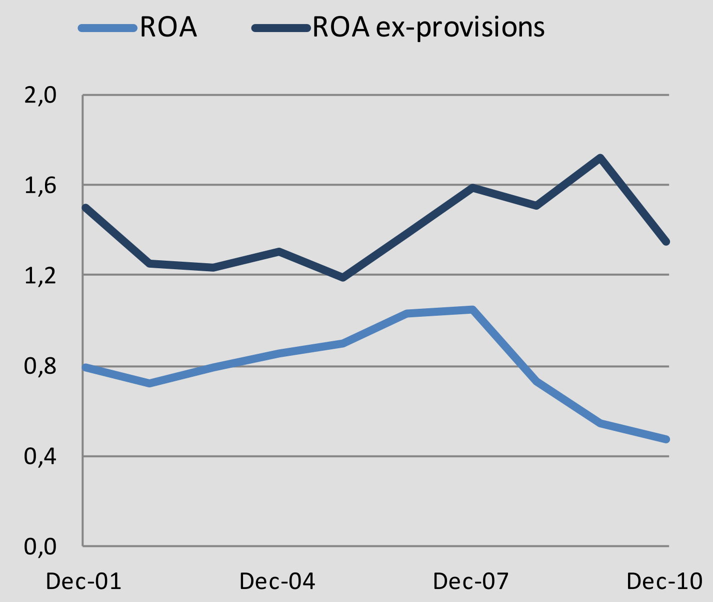
SPANISH BANKING SECTOR. PROFITABILITY

- **Banks' core business remains profitable looking ahead**

- **Increases in interest rates are, as historically has been the case for the banking business, favourable**

  - Sovereign spread is acting as a floor for the funding costs of Spanish institutions
  - Assets, to a great extent, are linked to Euribor

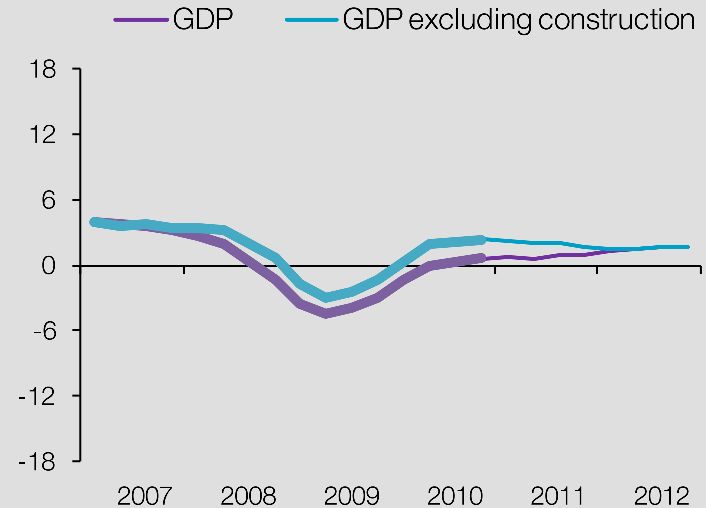
ROA, %. Deposit institutions



SPANISH ECONOMY. ECONOMIC GROWTH

- **Spanish economy is already growing, although at a low pace**

GDP Growth (yoy, %)



- **Potential growth has been affected by the crisis, but remains higher than in the main euro area average according to OECD estimates**

Potential Output Growth
(OECD estimates)

%	2001-2007	2010-2015	2016-2026
Spain	3.7	1.5	2.4
Euro Area	1.4	1.4	1.6

SPANISH BANKING SECTOR. CONCLUSIONS

1. **Problems exist, but they are limited in scope and manageable**

2. **There is a strategy in place: capitalisation conditioned on restructuring + transparency**

3. **Most of the restructuring has already been done**

4. **Looking ahead the core business of Spanish banks is profitable**

A FINAL REFLECTION. FROM AN INTERNATIONAL PERSPECTIVE THERE IS A NEED OF:

- **Strong regulation**
- **Strong supervision**
- **Enhancing transparency (i.e. disclosure of risks) and promoting market discipline**