

The Spanish banking sector: outlook and perspectives

José María Roldán

Director General of Banking Regulation
Banco de España

London

27th and 28th May 2010

CONTENTS



- **Outlook for the Spanish banking sector**
- **The Spanish provisioning model**
- **The Fund for the Orderly Restructuring of the Banking Sector (FROB)**
- **Institutional Protection Schemes**
- **Update of the restructuring process of the savings banks sector**
- **Conclusions**

TAKEAWAY OF THE PRESENTATION



- **The sector is resilient overall**
- **There is differentiation among institutions**
- **The sector needs to adjust its capacity**
 - Institutions have begun an adjustment process
 - The FROB will contribute to this process for those institutions that need it

OUTLOOK FOR THE SPANISH BANKING SECTOR

CREDIT



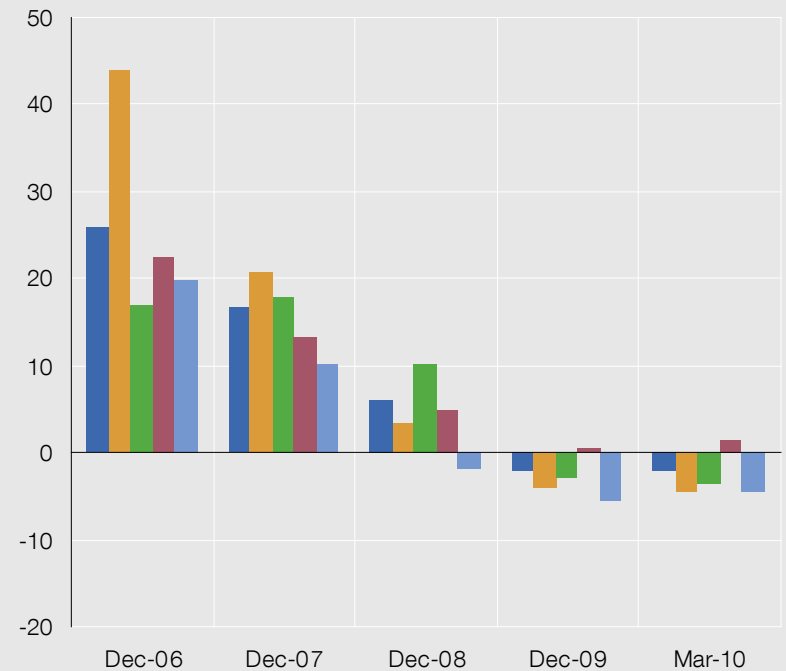
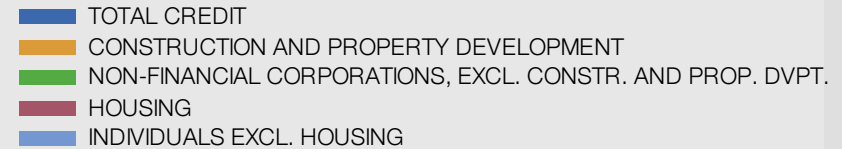
- **The downward trend of credit to the resident private sector has persisted. The economic downturn entails less demand for credit ...**

- ... and institutions tighten their credit standards due to the deterioration of clients' credit quality

- **The slowdown in credit, with differences in intensity across institutions and sectors of activity, can be seen across the board**

YEAR-ON-YEAR RATE OF CHANGE IN CREDIT TO THE RESIDENT PRIVATE SECTOR (%)

Deposit institutions. ID



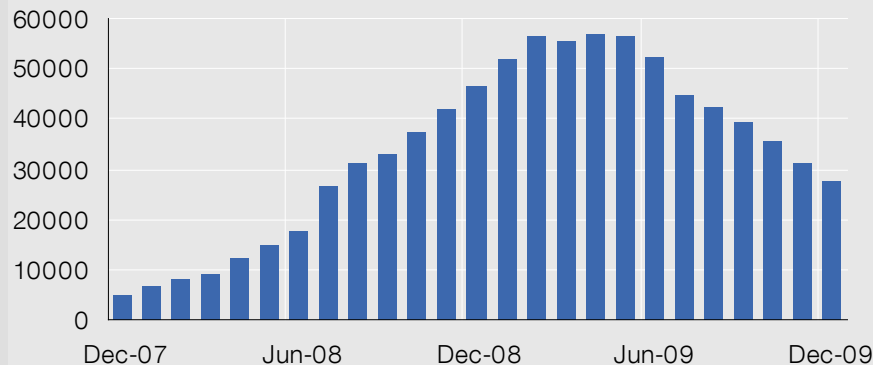
OUTLOOK FOR THE SPANISH BANKING SECTOR

DOUBTFUL ASSETS



- **Doubtful assets** of the resident private sector in Spain **grew sharply** (45.3% year-on-year in Dec. 2009 and 23% year-on-year in March 2010)
- **As did the doubtful assets ratio** for the resident private sector (5% in Dec. 2009 and 5.3% in March 2010)
- **The rate of increase** of doubtful assets and of the ratio of doubtful assets **have moderated significantly over recent months**

DOUBTFUL ASSETS OF CREDIT TO RESIDENT PRIVATE SECTOR. YEAR-ON-YEAR CHANGE (€m)
Deposit institutions. ID



OUTLOOK FOR THE SPANISH BANKING SECTOR

DOUBTFUL ASSETS

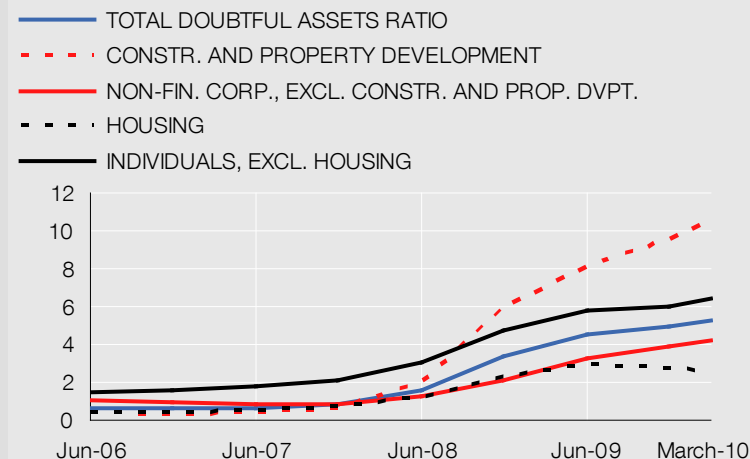


- **The doubtful assets ratio for the resident private sector is higher in those sectors whose performance is most closely linked to the economic cycle**

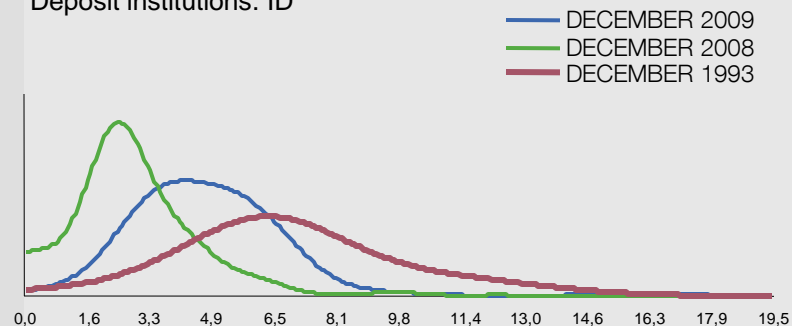
- **Particularly, in the construction and property development sector**

- **The doubtful assets ratio shows a high degree of dispersion across institutions**

DOUBTFUL ASSETS RATIO BY SECTOR OF ACTIVITY (%). Deposit institutions. ID



DISTRIBUTION OF DOUBTFUL ASSETS RATIO OF CREDIT TO THE RESIDENT PRIVATE SECTOR (%) Deposit institutions. ID



OUTLOOK FOR THE SPANISH BANKING SECTOR

DOUBTFUL ASSETS



- **The doubtful assets ratio of credit for consumption is 6% in Dec. 2009 and 6.4% in March 2010**

- This lending is more related to the cycle, but its weight in deposit institutions' credit portfolio is low (8%)

- **Lending for house purchase shows a low doubtful assets ratio: 2.8% in Dec. 2009 and 2.6% in March 2010 (36% of the credit portfolio of deposit institutions)**

- This is because of the type of business in which Spanish banks engage (traditional retail banking), and is also due to the significance of the good financed for households
- The existence of collateral and the LTV limits potential loss

- **Non-financial corporations other than construction and property development firms show a doubtful assets ratio of 3.9% in Dec. 2009 and 4.2% in March 2010**

LTV OF MORTGAGES FOR HOUSE PURCHASE

		Loans granted over total mortgages		
%				
Resident households				
First mortgage		90,9		
of which:				
for the first residence		79,9		
		LTV		
		LTV<80%	80%<LTV and LTV<100%	LTV>100%
Household mortgages				
For housing		80,9	15,2	3,9
For first residence		80,4	15,7	4,0
For second residence		90,4	7,3	2,3

OUTLOOK FOR THE SPANISH BANKING SECTOR CONSTRUCTION AND PROPERTY DEVELOPMENT (1)



- **The construction and property development sector represents a significant risk for the Spanish banking sector**
- This risk is due to the very sharp adjustment process in this sector ...
- ... and also because of **the volume of exposure: €445 billion as at Dec. 2009**
 - This amount of exposure includes all loans to construction and property development firms, because sometimes classifying a credit in one sector (construction) or the other (property development) is not straightforward
 - But not all of these loans entail exposure to the residential construction and property development sector
 - *Firms from these sub-sectors are also active in other business (i.e. energy, airport infrastructure, activity arising from public investment ...)*
 - These banks' exposures are to the commercial residential real estate sector. Lending intended to finance shopping centres and similar buildings (i.e. commercial real estate) is not an issue for Spanish deposit institutions



- **The potentially troubled exposure amounts to €165.5 billion**

- **Doubtful loans: €42.8 billion**

- *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: €59 billion**

- *Loans showing some general weakness associated with the fact they are to a specific troubled group or sector, but which do not translate into losses for the borrower*

- **Asset foreclosures, dation in payment and acquisitions: €59.7 billion**

- *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: €4 billion**

OUTLOOK FOR THE SPANISH BANKING SECTOR CONSTRUCTION AND PROPERTY DEVELOPMENT (3)



- Banco de España accounting rules requires specific provisions to be set aside

	Specific coverage (€bn), (a)	% of coverage (b)
Doubtful assets	17.7	41.4
Substandard loans	7.6	12.9
Foreclosures	13.0	21.8
Write-offs	4.0	100

(a) Amount of specific provisions already constituted for each type of potentially troubled exposure

(b) % of coverage = specific provisions / amount of exposure, in %

- The coverage of the overall potentially troubled exposure is:

- 25% with specific provisions
- 35% including the stock of general provisions of the business in Spain
- 71% including recurring income (assuming that its level in 2010 is equal to that observed in 2009, while in 2009 it grew 18% y-o-y)



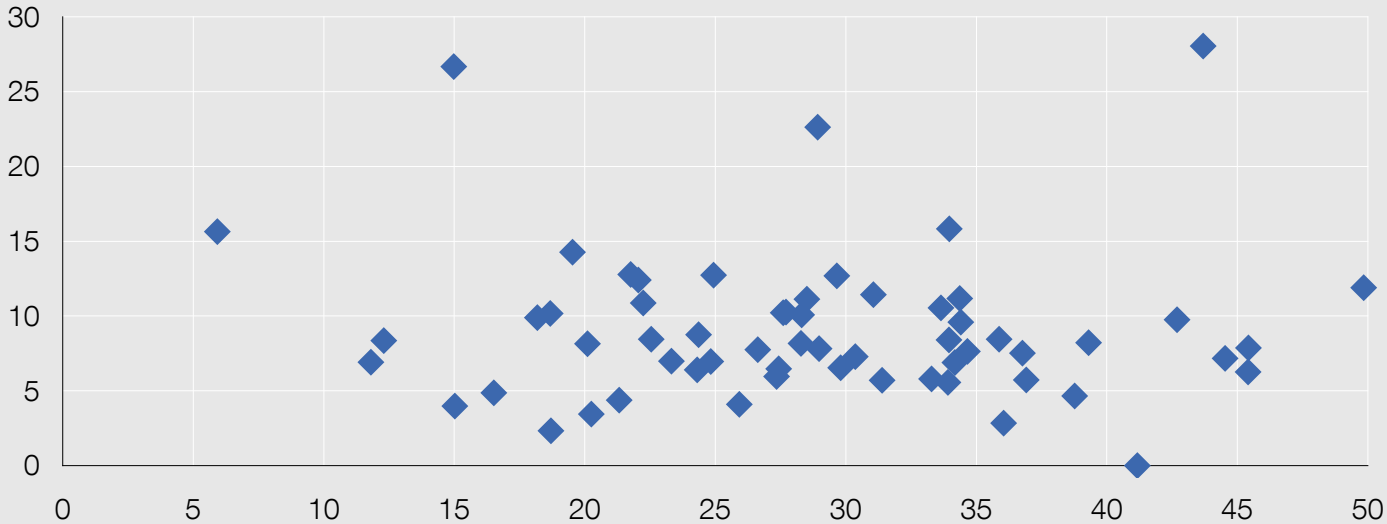
The sector as a whole has provisions in place for declines of over 50% in the average realisable value of collateral, without having to record additional losses

OUTLOOK FOR THE SPANISH BANKING SECTOR CONSTRUCTION AND PROPERTY DEVELOPMENT (5)



- If exposure to and default on credit to construction and property development are analysed together, it is clear that **institutions have selected and managed these risks differently**

DOUBTFUL ASSETS RATIO OF CREDIT TO CONSTR. AND PROP. DEVELOPMENT (y-axis) AND WEIGHT IN CREDIT TO THE RESIDENT PRIVATE SECTOR CREDIT (x-axis). DECEMBER 2009 (%) (a)



(a) The institutions considered account for 94% of the credit to construction and property development at the reporting date

OUTLOOK FOR THE SPANISH BANKING SECTOR

FUNDING (1)



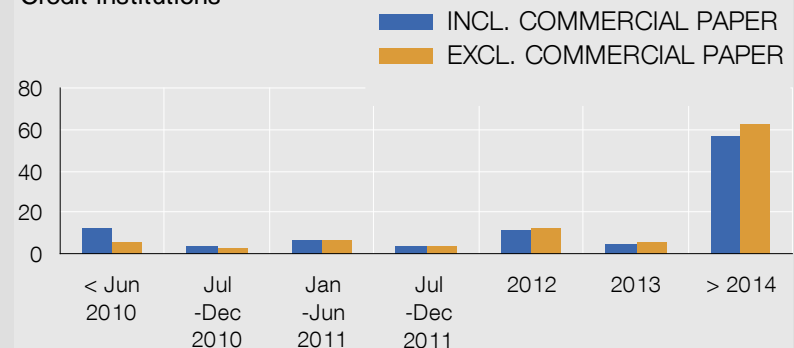
- Spanish institutions' **debt issues are mostly medium and long-term**, easing the debt refinancing risk

- Deposit institutions have stepped up their **efforts to attract deposits**

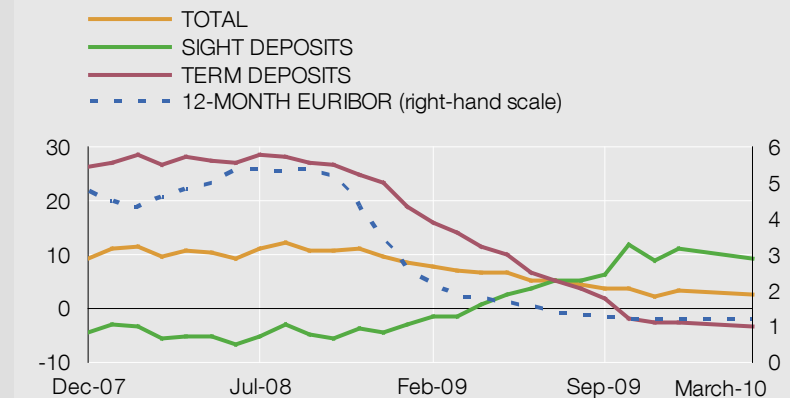
- The continued rate of growth of deposits raised from non-financial corporations and households declined somewhat in 2009

- The need for institutions to readjust their liabilities, raising their relative weight of deposits, is intensifying the **competition to attract firms' and households' savings**

OUTSTANDING MEDIUM AND LONG-TERM DEBT BY DATE OF MATURITY (%)
Credit institutions



DEPOSITS FROM NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS. YEAR-ON-YEAR RATE OF CHANGE IN DEPOSITS (%) Deposit institutions. ID



OUTLOOK FOR THE SPANISH BANKING SECTOR FUNDING (2)



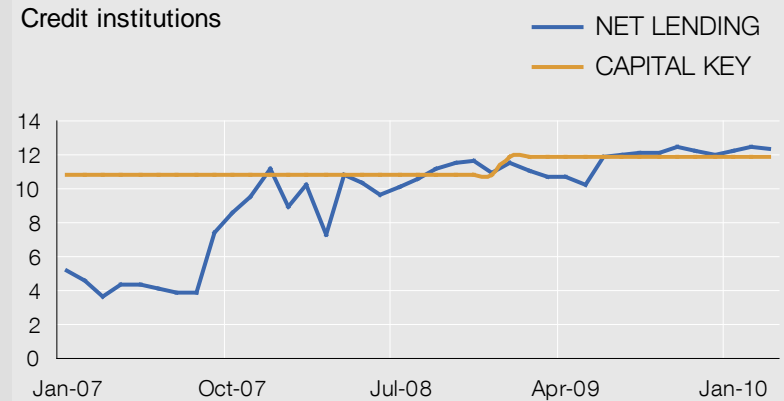
- Spanish deposit institutions have been obtaining more **funds from the ECB**

- The volume of funds obtained is **in line with the relative size of the Spanish economy in the Euro area, ...**
- ...and only represents 2% of the consolidated balance sheet** (Dec. 2009)

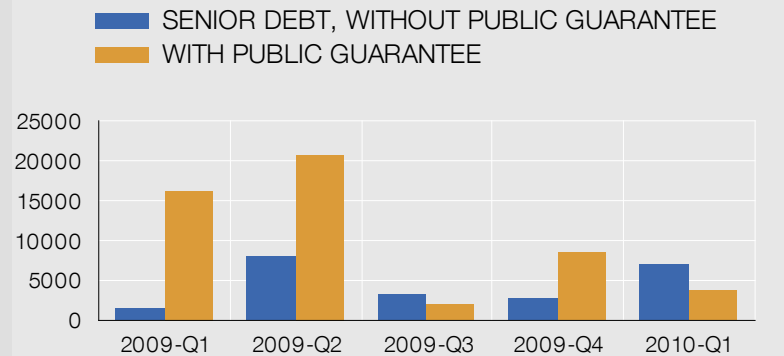
- Spain's larger institutions had been able to access the senior debt markets**

- But given the difficulties in funding markets, especially for institutions perceived as weak, **the volume of debt issuance backed by State guarantee exceeded that of senior debt issuance**

EUROSYSTEM NET LENDING RELATIVE TO SPAIN'S CAPITAL KEY (%)



DEBT ISSUES (€m). Credit institutions



OUTLOOK FOR THE SPANISH BANKING SECTOR

PROFITABILITY (1)



Main figures. Deposit institutions. Consolidated data

	€m	%CHANGE Dec.09 / Dec.08	% ASSETS Dec.09
Net Interest Income	70,475	22.7	2.04
Net Operating Income	61,253	18.0	1.77
Loan loss provisions	40,725	64.8	1.18
Group Net Income	18,562	-19.7	0.54
		Dec. 2008	Dec. 2009
ROE		12.9	9.0
ROA		0.91	0.66

- The sharp **growth of net operating income** has been **offset by the impact of higher specific loan loss provisions**
- **Cost-reduction efforts, but downside risks remain in place due to narrower margins and the foreseeable persistence of specific provisions**
 - Q1 2010 results shows a weaker evolution of net interest income

OUTLOOK FOR THE SPANISH BANKING SECTOR SOLVENCY (1)



- **Total solvency ratio: 12.2%**
- **Tier 1 ratio: 9.7%**
- **Core capital ratio: 8.1%**

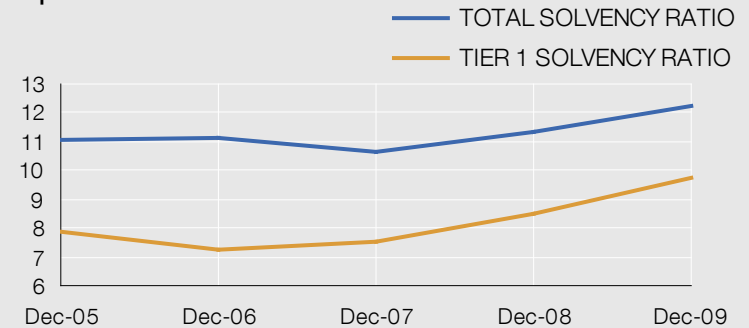
▪ **The improvement has been particularly robust in terms of their top quality own funds ...**

- **This places them in a favourable position for undertaking BCBS changes in Basel II**

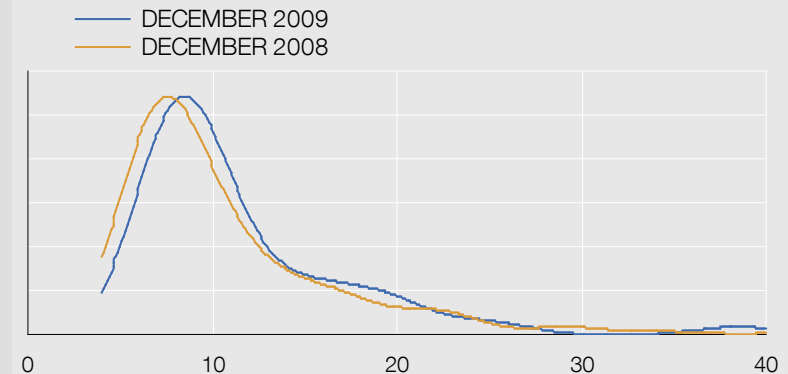
▪ **... while risk-weighted assets have remained unchanged (vs. Dec. 2008)**

▪ **Solvency increased for a high number of deposit institutions**

TOTAL AND TIER 1 SOLVENCY RATIOS (%).
Deposit institutions



DISTRIBUTION OF NUMBER OF INSTITUTIONS ACCORDING TO TOTAL SOLVENCY RATIO (%).



CONTENTS

- Outlook for the Spanish banking sector
- **The Spanish provisioning model**
- The Fund for the Orderly Restructuring of the Banking Sector (FROB)
- Institutional Protection Schemes
- Update of the restructuring process of the savings banks sector
- Conclusions



- **Specific provisions**

- **In Spain they are rule-based**

- *On the contrary, in most countries they are not rule-based: determining the provision depends on bank managers' judgement, globally endorsed by the auditor*

- **Banco de España guidance on specific provisions is transparent and public, setting minimum provisioning requirements**

- *Banco de España accounting guidance on specific provisions is set on the basis of objective features, such as the time past-due and loan characteristics*

- **On top of that, Banco de España also requires specific provisions for asset repossessions**

- *At the outset repossessions are marked-to-market minus a specific provision of 10% to take into account potential selling costs. Another 10% is added one year after the foreclosure*



- **Dynamic provisions**

- This type of provision, **based on a transparent and automatic mechanism, allows earlier detection and coverage of credit losses in loan portfolios**
- The idea behind the mechanism is simple: **there is a gap between credit risk being taken and credit risk appearing in the profit and loss accounts of banks**
- Thus, the dynamic provision regulation **fosters the accumulation by banks of provisions during upturns** –when credit grows sharply and specific provisions are low- **so that the accumulated stock can be used when bad loans start to increase**



THE SPANISH PROVISIONING MODEL

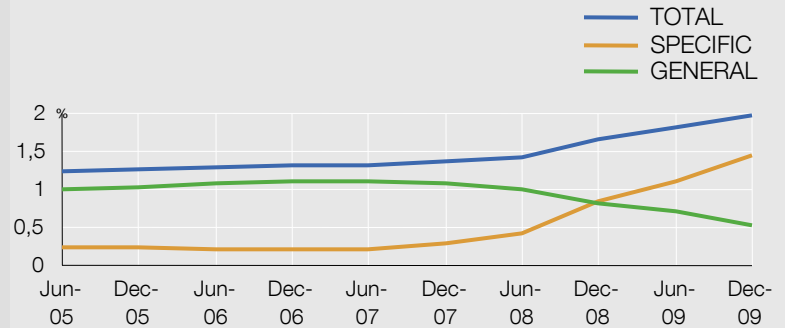
- **Total provisions increase in downturns, although to a lesser extent than if the countercyclical mechanism did not exist**

- Total provisions are less procyclical without being completely insensitive to the cycle

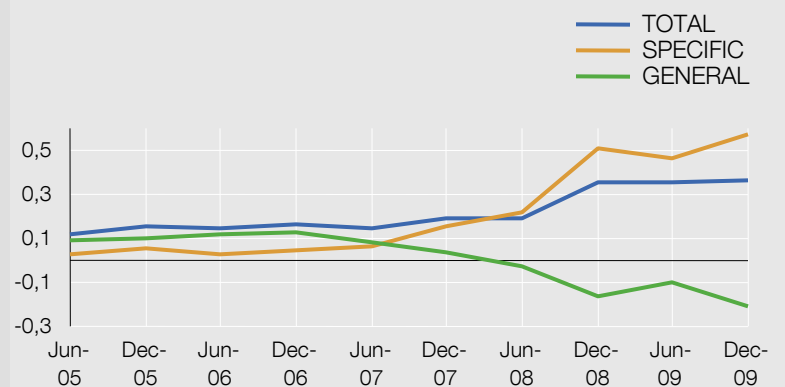
- **The flow of provisions follows a similar pattern, reflecting the macro-prudential approach inherent in the Spanish provisioning system:**

- Between mid-2007, when lending entered a phase of deceleration, and end-2009, the flow of specific provisioning as a percentage of loans grew more than tenfold, while the flow of total provisions merely doubled

STOCK OF PROVISIONS / LOANS (%). Deposit institutions, excluding European foreign branches



FLOW OF PROVISIONS/LOANS (%). Deposit institutions, excluding European foreign branches





- **The countercyclical mechanism** of dynamic provisioning is based on the **comparison between expected losses and specific provisions**
 - This expected loss model is the approach that the IASB is moving towards
 - If its proposal comes into effect, the present incurred loss model will be replaced by an expected loss model, an approach that has underpinned the Spanish provisioning model since mid-2000
- Spanish banking **institutions have benefited from this provisioning model**, especially when doubtful assets and bad debts increased sharply
- **That success does not mean that the system can be considered a silver bullet**
- The lessons of the crisis and the final proposal of the IASB **may make a review of the calculation methodology used for Spanish provisioning advisable**



- On Wednesday 26 May, the Banco de España published for public consultation a **revision of the impairment guidance regarding specific provisions for non performing assets**
- There are **three reasons for the change**:
 - To take into account the lessons learnt from the financial crisis
 - To introduce a complete and consistent framework for the treatment of collateral in credit operations
 - To simplify and rationalise the number of calendars used to estimate the percentage of specific provisions that institutions must set aside as a minimum for non performing assets
 - *Reduction from five to one calendars*



- **The content of the reform:**
 - **Simplification of the above-mentioned calendars**
 - **Treatment of collateral**
 - **Treatment of repossessed assets**



- In Spain the system of specific provisions is based on statistics coming from our Credit Register that indicates that loans belonging to a specific portfolio will have different impairment ratios depending on the moment when the breach of contract happened
- For these reasons, **the impairment estimation for homogeneous portfolios is based on calendars** (*i.e. it sets out the minimum provisions needed for non-performing assets*)
- **The proposal unifies the calendars**, reducing them from 5 to 1, recognising impairment for the amounts not covered by collateral
 - *Until now, the time to achieve a total coverage goes between 2 years and 6 years for high quality collateralised loans. Now, a total coverage is reached after 1 year once consideration is given to the collateral values after specific haircuts are applied*

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



- The current impairment guidance does not include a consistent and coherent treatment for collateral. This was indirectly recognised through the existence of different calendars. The reform proposes an **explicit recognition of collateral** and offers a **consistent treatment for those credits that are collateralised**:

- The value of the collateral is recognised
- The value of the loan that it is not covered by the collateral is treated in accordance with the proposed calendar, of which there is now only one

- **To estimate the value of the collateral**

- **Minimum value of collaterals (cost; appraisal) 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 state):* 40%
- *Land lots and other real estate assets (commercial residential real state):* 50%



- **The proposal guides institutions on how to value *repossessed assets***
- They should consider **the lower of two values**:
 - *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%)*
 - *The appraisal value of the assets, less the attendant sale costs, which, at a minimum, should be considered at 10%*
- **When these assets are kept on the balance sheet for long periods, this is considered to be a sign of their deterioration.** The rationale is that if credit institutions are not able to sell the repossessed assets in the market, that is a sign of the existence of problems (i.e. credit institutions are not real estate companies). The minimum impairment estimation must be:
 - **After one year: 20%**
 - **After two years: 30%** (If there is a new appraisal value and it shows that there is no damage beyond 20% no need to increase provisions; if the new appraisal value shows additional damage above the 20%, provisions must be close the gap between the 20% and the loss derive from the new appraisal value)



- An **impact assessment** has been made of the changes in the domestic activity of Spanish credit institutions
- A sample of **representative credit institutions** has been chosen
- The impact is calculated comparing the estimated volume of specific provisions and net income before taxes in year 2010 with and without the proposals. It is observed that:
 - In year 2010 the proposals would entail an increase in specific provisions of 2%, which would translate into a reduction in net income before taxes of around 10%
 - If consideration is given to the greater provisioning requirements derived from the treatment of repossessed assets in 2011, and this is applied to 2010, the impact would be an increase of nearly 7% in provisions instead of 2%

CONTENTS

- Outlook for the Spanish banking sector
- The Spanish provisioning model
- **The Fund for the Orderly Restructuring of the Banking Sector (FROB)**
- Institutional Protection Schemes
- Update of the restructuring process of the savings banks sector
- Conclusions

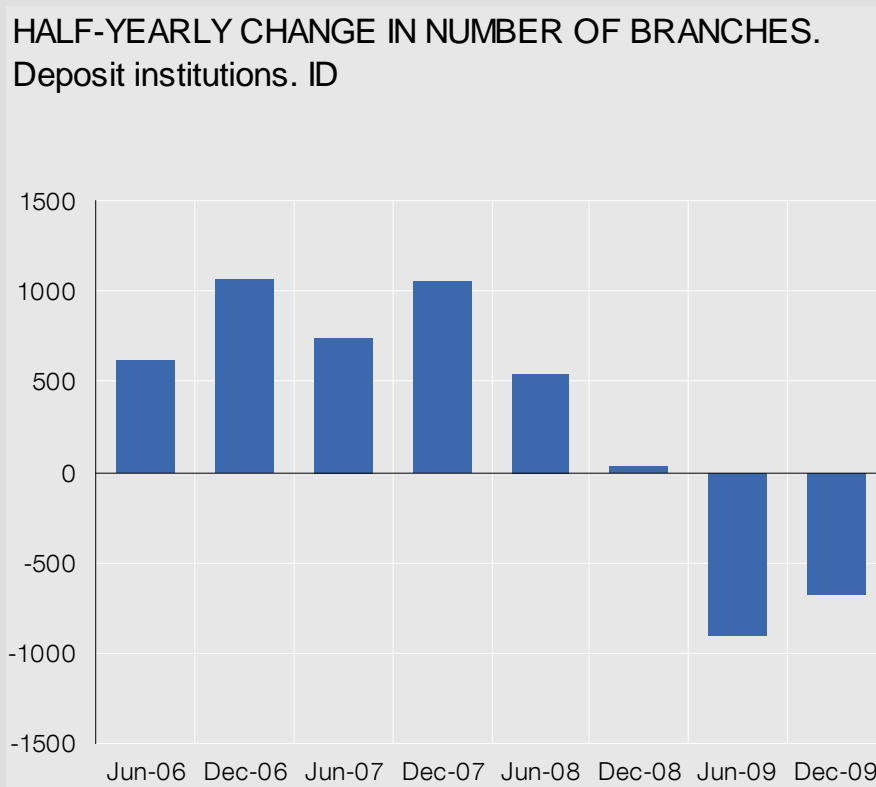


■ The rationality of the system:

- Medium-term profitability of banking institutions is key in order to avoid problems because this means that they will have the capacity to absorb the legacy assets
- But there are challenges for some institutions: higher pressures on profit and loss accounts in a context of higher funding costs and lower levels of banking activity
- The FROB is an instrument that facilitates the adjustment process of those institutions to ensure that they return to a medium-term profitability path: this is the best way to absorb legacy assets. It will also contribute to adjust the excess capacity of certain institutions. This objectives will be attain with the minimum costs for taxpayers
- By June 30th: targeted end for the preventive merger processes



- **Institutions have begun an adjustment process** (strengthening their own funds, increasing deposit-taking and containing operating costs)





- **Public authorities have adopted the necessary measures (i.e. the FROB) to facilitate this process in an orderly manner. The FROB has already been approved by the European Commission**

- **Two key objectives**

- **To ensure that the Spanish banking sector is in a good position to sustain economic growth once the real economy starts its recovery**
- **To ensure that the process entails the lowest costs for taxpayers**

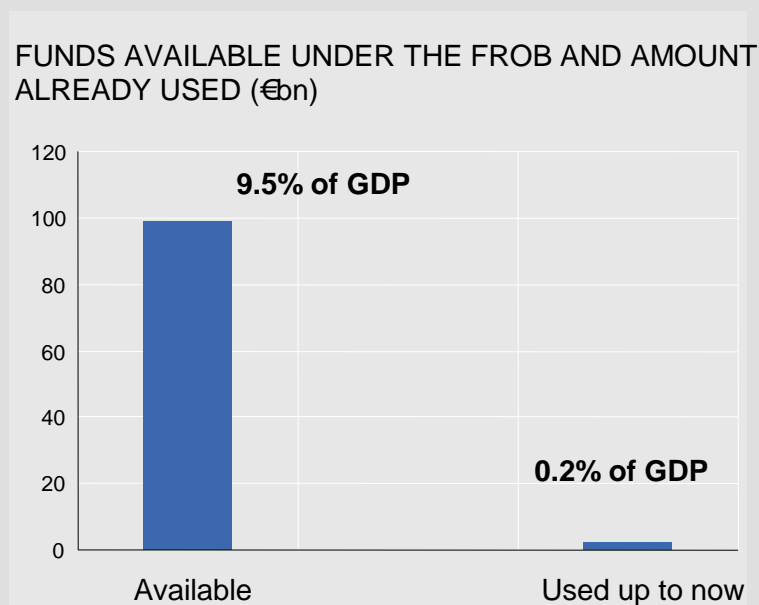
- **Based on the following general principles**

- **Widespread recapitalisation plans are avoided**, by addressing the problems of credit institutions individually
- **The accountability of the shareholders and managers** of the institutions subject to restructuring is promoted

THE FUND FOR THE ORDERLY RESTRUCTURING OF THE BANKING SECTOR (FROB)

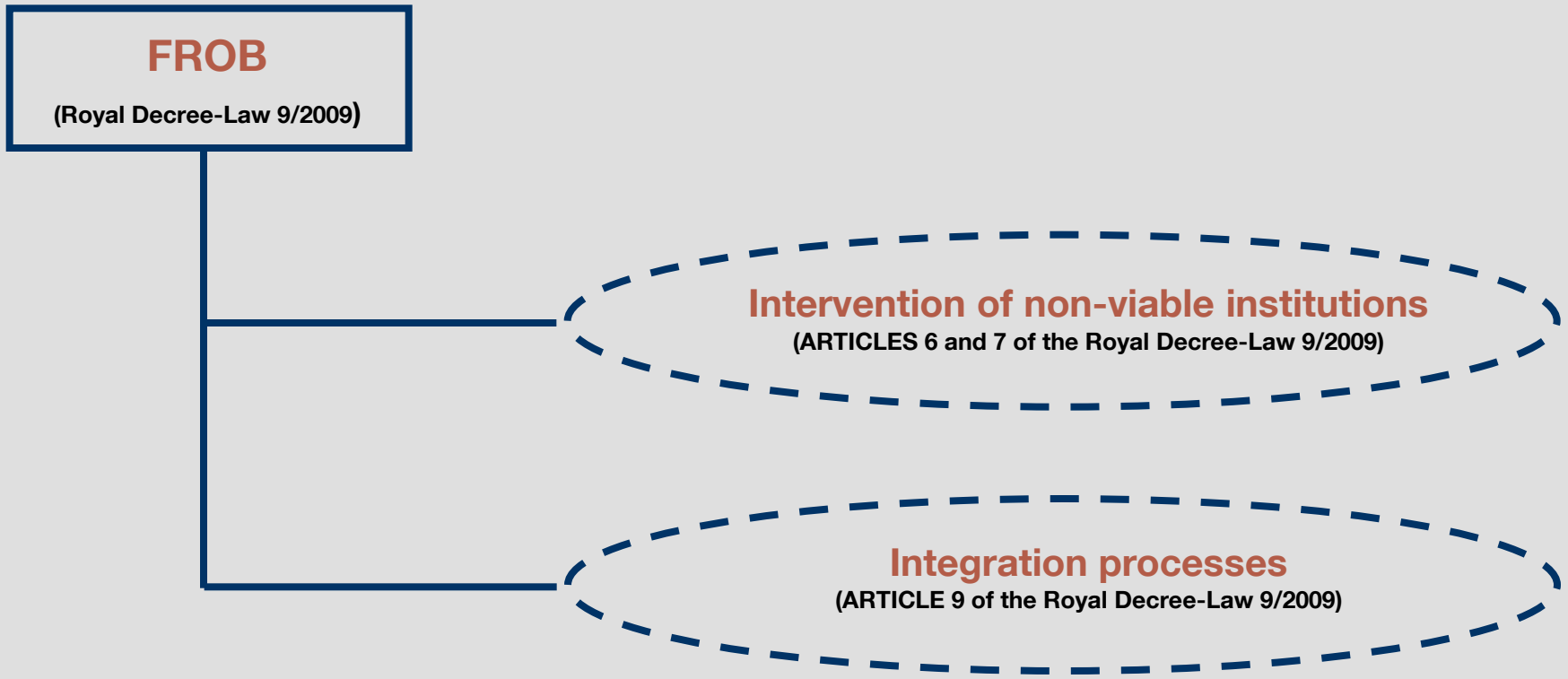


- Initial endowment: €9 bn
 - €6.75 bn by the State
 - €2.25 bn by the DGFs
- Increasing the initial amount assigned up to ten times, i.e. **up to €99 bn** with the approval of the Ministry of Economy (**€27 bn have already been approved**)
 - This amount does not reflect an estimation of the potential losses for the Spanish banking sector





- The FROB is based on two pillars





The FROB as an intervention mechanism (articles 6 and 7)

- **For institutions which could present weaknesses that affect their viability**
- **Designed to allow a rapid and effective intervention**
- **It will act sequentially, prioritising private solutions:**
 - **First**, the institution affected will look for a **private solution, including the participation of the DGFs**
 - If there is not a private solution, **the FROB will take control of the institution and will be appointed as its provisional administrator**. A restructuring plan will be drawn up for the merger or takeover of the institution or the full or partial transfer of its assets and liabilities, and financial support measures could be included in the plan



The FROB also facilitates integrations processes of viable institutions (article 9)

- **It will facilitate mergers or rationalisation process of viable institutions with the objective of** consolidating their medium-term efficiency by strengthening their capital
- In that case the institutions must submit **an integration plan including:**
 - Improvements in efficiency; rationalisation of their administration; and restructuring of their production capacity
- When the plan is approved by the Banco de España, **the temporary aid given by the FROB is to reinforce the own funds of the institution acquiring preferential holdings**
- **Of relevance is the fact that these funds are**
 - **Costly:** their remuneration is 7.75%
 - **Temporary:** they have to be repaid in five years
 - **Conditional:** they are subject to the restructuring of the institutions



- **In order to understand how swiftly the FROB must act it is important to consider three relevant questions**
 - Unlike in other countries, the international financial crisis has not caused massive losses for deposit institutions in Spain, meaning that **widespread bail-out programmes have not been needed. The emphasis of the FROB is to facilitate the orderly restructuring of the sector** by reinforcing medium-term profitability and solvency through integration processes
 - Secondly, and related to the aforementioned argument, **the FROB prioritises private restructuring processes**. While institutions are viable, they have the initiative. The objective is **to minimise the use of public funds**
 - Finally, **some of the institutions that have incurred the biggest imbalances are savings banks, which have distinctive governance arrangements and structures** which will tend to draw out the process

CONTENTS



- Outlook for the Spanish banking sector
- The Spanish provisioning model
- The Fund for the Orderly Restructuring of the Banking Sector (FROB)
- **Institutional Protection Schemes**
- Update of the restructuring process of the savings banks sector
- **Conclusions**



- **According to the Capital Requirements Directive, an Institutional Protection Scheme (IPS) is defined as**
 - “A contractual or statutory liability arrangement which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy in case it becomes necessary”

- **Thus, for an IPS to exist there must be a solidarity arrangement whereby the members of a group undertake to support each other, in terms of liquidity and solvency, if necessary**

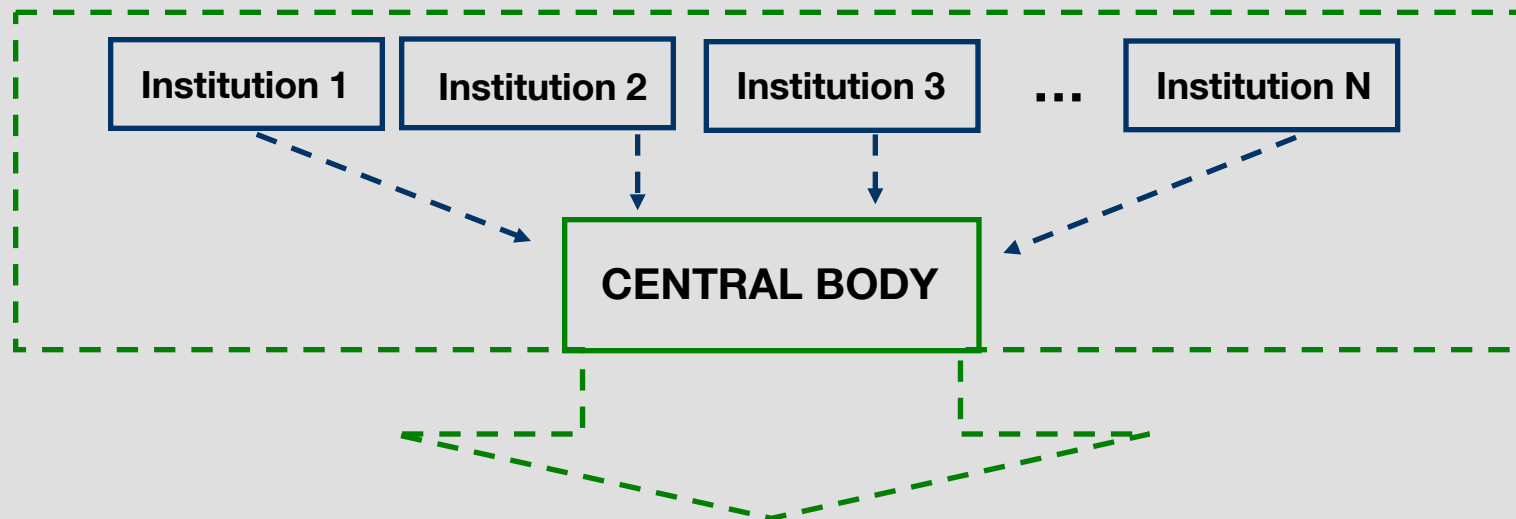
- Under this general definition **the varieties of IPSs are almost infinite.**



INSTITUTIONAL PROTECTION SCHEMES

- **IPSS can be classified in two main groups**
 - **Narrowly defined IPSSs:** groups of institutions whose solidarity arrangements do not establish legally binding mutual support commitments
 - **Strengthened IPSSs:** groups of institutions whose solidarity arrangements define legally binding sound contractual commitments
 - *The key feature is a central body which combines cash management, product development and strategic planning, and ...*
 - *... typically supervision is conducted at group level*
- **The constitution of IPSSs is a possibility available to Spanish deposit institutions** to conduct their restructuring process
 - **Royal Decree-Law 6/2010 of 9 April 2010 established additional conditions for IPSSs in order for them to be considered strengthened and deemed to be groups for regulatory purposes**

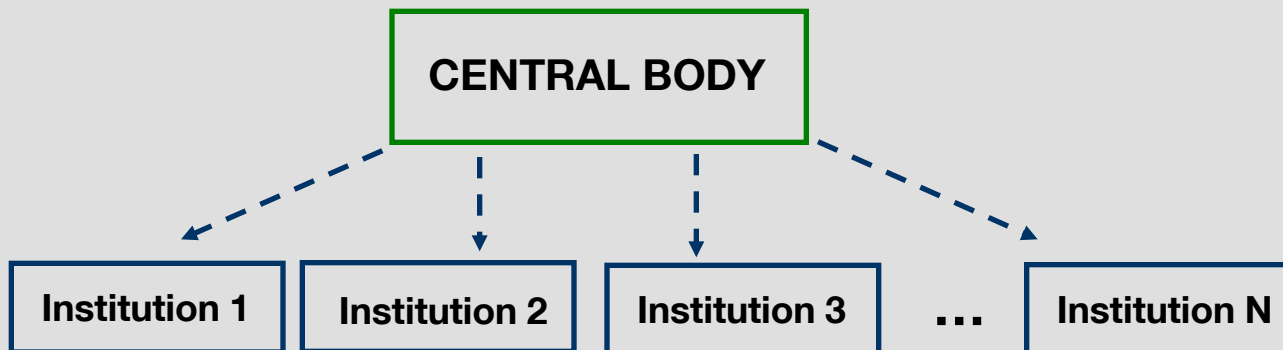
INSTITUTIONAL PROTECTION SCHEMES



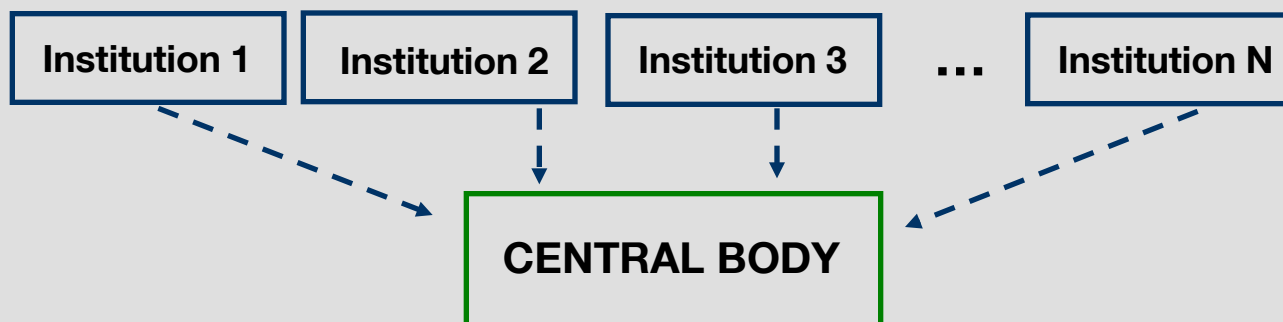
- There must be a **central body that determines the policies and business strategy, and internal risk control and management**. It will be responsible for complying the regulatory requirements on a consolidated basis of the IPS
- **The central body must be one of the credit institutions integrating the IPS or another credit institution participated in by all of the integrating institutions**, with the former also being part of the IPS
- **Include a liability mutual arrangement for the solvency (to at least 40% of each participating institution's eligible own funds) and liquidity of the institutions integrating the IPS**. The mutual commitment will include the necessary provisions so that support among the integrating institutions will be on the basis of using immediately disposable funds
- **Institutions mutualise at least 40% of their results**, thereby sharing joint business income
- **There is a minimum term of 10 years**, with severe penalties to deter members from leaving the IPS
- Banco de España must decide whether there is **compliance with the regulatory requirements enabling advantage to be taken of 0% risk weighting between the members**



- At first sight this structure could seem strange ...



- ... but not so strange ...



- In fact, it looks very promising in the medium term

CONTENTS

- Outlook for the Spanish banking sector
- The Spanish provisioning model
- The Fund for the Orderly Restructuring of the Banking Sector (FROB)
- Institutional Protection Schemes
- **Update of the restructuring process of the savings banks sector**
- **Conclusions**

RESTRUCTURING PROCESS OF THE SAVINGS BANKS SECTOR - UPDATE



- Until now it is possible to distinguish four types of restructuring processes

Approved by Banco de España and FROB	12% of total assets of the savings banks sector
Cajas Catalunya, Tarragona and Manresa	€1,250 m of preference shares to be repaid in five years
Cajas Duero and España	€525 m of preference shares to be repaid in five years
Cajas of Manlleu, Sabadell and Terrasa	€380 m of preference shares to be repaid in five years
Approved by Banco de España but no funds from the FROB	7% of total assets of the savings banks sector
Cajas Navarra, Burgos and CajaCanarias (Banca Cívica)	
Unicaja and Caja Jaén	
Process under development	18,5% of total assets of the savings banks sector
Caixanova and CaixaGalicia	
CajaSol and Caja Guadalajara	
Cajas Asturias, CCM, CAM, Cantabria and Extremadura	
Cajas under receivership	1,6% of total assets of the savings banks sector
CCM	DGF of the savings banks
Cajasur	FROB

- Thus, until now 23 out of 45 savings banks that represents a 39.1% of the total assets of the savings banks sector are in the process of being restructured. For those receiving public funds from the FROB the projects consider reductions of the offices branches of 25% on average, and reductions of staff between 15% and 18%

CONTENTS

- Outlook for the Spanish banking sector
- The Spanish provisioning model
- The Fund for the Orderly Restructuring of the Banking Sector (FROB)
- Institutional Protection Schemes
- Update of the restructuring process of the savings banks sector
- **Conclusions**

CONCLUSIONS



- **The process of restructuring the banking sector through Article 9 (preventive mergers) is progressing and will end by June 30th**
- **The rules of the game are clear and transparent**
 - **Regulatory rule based system**
 - **Monthly public information on key financial variables for the banking sector (e.g. non performing loan ratios)**
 - **More detailed information and assessments in the Financial Stability Report**

THANK YOU

BANCO DE **ESPAÑA**
Eurosistema

DG. REGULATION

