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The financial crisis and the restructuring of the Spanish banking system

APIE – UIMP Course (Santander)

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Let me begin by thanking the APIE (the Spanish Association of Economics Journalists) and the Menéndez Pelayo University for inviting me to deliver the closing address at this seminar, which has discussed matters of great interest for our economy and financial system.

This is the third year I have come to Santander for this session, and the second year running that I will be briefly reflecting on the financial crisis and the restructuring of the banking system. That I should be here again is no strange occurrence. Indeed, it was foreseen by the organisers since we are experiencing the deepest and most extensive crisis in recent decades, and we face a far-reaching restructuring and reform of savings banks.

But my address today is from a different perspective than that of my last visit.

In June 2010 the Royal Decree-Law that created the Fund for the Orderly Restructuring of the Banking Sector (FROB by its acronym) had been in force for a year. One of its aims was to boost integration processes to create sounder and more efficient institutions. At that time the main negotiations between savings banks to draw up the new map of the sector had already taken place, and the FROB had committed its first aid in this connection. But some of the key elements to entrench the reforms and restore external confidence in our financial system were still pending.

In fact, only a month later, in July 2010, the results of the stress tests of credit institutions, co-ordinated at the European level, were published; the Banco de España agreed to amend the regime governing accounting provisions; and the government approved a key reform on the legal regime of savings banks. Then, in February 2011, the Royal Decree-Law on the reinforcement of the financial system was enacted, and its rules are currently being applied.

This year we can roundly state that the restructuring of savings banks has moved into its final stage. Thereafter, we will have a smaller set of institutions (from 45 original savings banks there are now 18) and one that is more efficient and better capitalised, capable, along with the rest of our banking system, of providing the intermediation services our economy needs for the recovery to take root and to contribute to our citizens' well-being.

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The road is undoubtedly proving to be a long and complex one. Far behind us now is the summer of 2007, when the sub-prime mortgage crisis broke, spreading its risks across agents and markets through securitisations and credit derivatives. That episode, which did not initially impact Spanish banks as they had no investments in those products, was actually the trigger for a chain of events and effects on the world economy and financial markets that would soon be felt in Spain.

The first symptom seen was the deterioration in financing and liquidity conditions. The authorities responded to this with support measures, such as the programmes for the purchase of financial assets and the backing of debt issues, and the European Central Bank set in place its new and ample liquidity provision criteria.

In late 2008 the Spanish economy went into recession. The decline in output and rising unemployment placed upward pressure on bank and savings-bank doubtful assets ratios and the subsequent need for loan loss provisions. This combined with the increase in financial costs owing to growing dependence on wholesale funding and to sudden difficulties on these markets. Moreover, many institutions, highly concentrated in the real estate development and construction sector, were faced with the housing market grinding to a halt.

What's more, savings banks had a singular legal regime, associated with their legal status, that entailed clear limits on their ability to raise top-quality capital and to set in place the governance rules needed to retain the confidence of third-party investors as to their future.

Given this outlook, there was an evident need to restructure the sector and to support the process with an instrument that would help strengthen the solvency of those institutions that decided to pursue plans to improve their efficiency by means of mergers or other integration operations. In July 2009 the FROB was duly created. And over the course of 2010 it granted – or committed itself to – aid amounting to €11.6 billion for eight integration processes (although one of these did not finally go ahead when the initial Banco Base project collapsed) and for the restructuring of a non-viable institution, CajaSur, and its integration into BBK. The other savings bank officially intervened due to its lack of viability, Caja Castilla-La Mancha, received aid from the Deposit Guarantee Fund, at a time when the FROB had not yet been created.

The year 2010 also saw successive episodes in which the public debt of euro area countries whose finances looked weak was punished. In spring we witnessed the Greek crisis and, at the end of the year, the Irish crisis. Although Spain's macroeconomic indicators were not in the least comparable with those of Greece and Ireland, these episodes affected Spanish public debt spreads, owing to the uncertainty and to the difficulty ever-present in these situations of correctly assessing the information available. Later, into 2011, the country affected was Portugal, although at this stage of market tensions Spain was able to distance itself from the eye of the storm thanks to its resolute reforms policy.

During 2010 the Banco de España also pursued a series of initiatives to help generate much-needed confidence. Firstly, in July it took transparency to a new level with the publication of the results of the stress tests, both because of the high proportion of institutions analysed (representing 95% of the system, compared with the figure of 50% required in Europe) and the degree of detail of the information provided. Secondly, it reformed the provisioning system that same month, to ensure appropriate balance-sheet write-downs. And thirdly, it urged institutions to provide the market with highly accurate information on their exposures to the real estate development and construction sector and on their financial structure and liquidity position.

Likewise in July 2010, Parliament approved the savings banks reform, included in Royal Decree-Law 11/2010. This paved the way for a new legal structure for savings banks, under which the pursuit of their banking activity may be through a bank, to which the bulk of assets and liabilities are transferred. This corporate model, conceived for adoption on a voluntary basis, although it has become obligatory for savings banks that receive further aid as I shall mention later, is imposing itself extensively on the sector owing to its advantages in terms of the ability to tap the markets for capital, to promote best management practices and to generate the necessary confidence on the part of customers and investors.

As initially stated, we are in the final stage of the savings bank restructuring process, implementing the strategy envisaged in Royal Decree-Law 2/2011 approved by Parliament in February. Underpinning this legislation are three pillars.

First, a very significant increase in solvency. All institutions shall comply with a core capital ratio, in which only top-quality instruments are eligible, of 8%, rising to 10% in the case of institutions that rely on wholesale markets for at least 20% of their funding and none of whose share capital or voting rights are placed with third parties.

Second, FROB backing for those institutions that do not reach these new minimum capital levels by their own means.

Third, new arrangements for the instrumentation of FROB aid, which now ceases to be provided as preference shares, taking rather the form of subscription to shares in the bank resulting from the conversion of the savings banks concerned.

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On 10 March 2011 the mechanisms envisaged in the new regulations were set in train with the publication by the Banco de España of the situation regarding institutions' capital. Twelve banks (four commercial banks and eight savings banks) did not reach the figures required to comply with the ratio, needing an aggregate additional amount of €15.15 billion. Finally, the number of institutions with a shortfall rose to 13 following the collapse of the Banco Base Institutional Protection Scheme (IPS).

Under the new regulations, institutions with a shortfall submitted their strategy and compliance timetable to the Banco de España, which were approved on 14 April. The following day the FROB agreed to the strategies submitted, undertaking to provide the funds needed to those institutions which, as a priority option or alternative, had decided to resort to FROB aid to comply with the new ratio.

The four banks that did not attain the required minimum opted, in the case of the two subsidiaries of foreign banks, to be capitalised by their parents, and the two Spanish banks, to issue instruments eligible as core capital.

Depending on the strategy chosen, two groups can be distinguished among the nine savings banks indicated.

The first, comprising four institutions, has opted for an IPO or raising private capital.

The second, made up of another four savings banks, has opted to be capitalised by the FROB. There is a fifth savings bank that has proposed FROB backing as an alternative to a possible merger with another institution. In all these instances, the Banco de España received the recapitalisation plans ahead of the scheduled deadline.

The situation concerning the four savings banks or groups of savings banks that have considered raising private capital is as follows. The four already have banks through which they are indirectly going to pursue their financial activity, and in three cases the transfer to the new bank of financial

assets and liabilities has concluded following the approval of their respective assemblies and their mercantile registration. These four institutions have submitted on a precautionary basis their recapitalisation plans to the FROB should they not be able to obtain private capital, although this is a possibility they consider unlikely in pursuing their strategies.

Two of them, Bankia and Banca Cívica, are taking steps for a future market launch. If the plans proposed come to fruition, in less than 30 days these institutions will be listed, the process envisaged under the new regulations will have concluded, and they will operate with capital higher than the minimum requirement set in the new legislation.

Another two banks, Mare Nostrum and Effibank, are also negotiating placing their capital in private hands, and they intend to conclude the operation within the schedule set, placing the proportion necessary to obtain the level of own funds required to meet the new core capital ratio. In both cases, the avenue being explored, without ruling out other alternatives, is the direct placement of capital with wholesale investors.

Turning now to the other four savings banks, all of them have submitted their recapitalisation plans, a pre-requisite for applying for aid.

The plans are in two parts: a business plan, with projections for profitability, leverage, liquidity and efficiency (among other variables); and a series of specific commitments regarding corporate governance and cost-cutting.

These plans will be – and indeed are already – subject to scrutiny by various parties: by the Banco de España, which must give final approval; by the FROB and its external advisers, who may demand inclusion of commitments on top of those proposed, considering these as an essential input in the process of setting the price to be paid for the shares in which the FROB invests; and by the European Commission, as the aid provided must be compatible with the European criteria on “State aid” and budget deficits. All three institutions are currently analysing the plans received.

The savings banks, for their part, are taking the necessary steps remaining to adjust their structure to the new requirements. In some cases they have already created the new bank to which they will transfer their banking activity, and in others the necessary procedures are at different stages of completion. Subsequently, in July, their assemblies will adopt the resolutions segregating their assets and liabilities and definitively transferring their financial business to the new bank.

A key aspect will be the setting of the price at which the FROB will participate in the capital of the new banks. As an initial step, the leading audit firms hired in this connection are performing both financial due diligence (to confirm the reliability of the institution’s financial statements) and business plan due diligence (the reasonableness of the plan). Both provide relevant information for the economic valuation of the new bank. This work is conducted using methodological and procedural approaches devised and published by the FROB late last May, following advice from a panel of experts in order to include best market practices.

Under these approaches, financial due diligence must pay particular attention to loans and receivables, real estate assets and the investment portfolio, along with potential one-off transactions envisaged, and to potential areas of risk from a legal, tax and labour-related perspective. Business plan due diligence will focus on the reasonableness of macroeconomic

assumptions, growth, revenue, doubtful assets ratios and provisioning, costs, synergies and disposals.

Based on the institution's financial statements, on the business plan and on the due diligences, three independent experts – all acknowledged authorities in their field – hired by the FROB will deliver their opinion on the institution's market value and the percentage of capital to which the new investment is equivalent. To ensure the quality of the result, the FROB will use the conclusions of three experts, although it will not take into account valuations that deviate by more than 15% from the resulting mean value.

Determining the economic value of the institution is thus being done with the utmost care since, as the FROB indicated in its methodological note, this is of paramount importance from three standpoints: from that of Community competition rules, to ensure that public aid is granted on an arm's length basis; from that of the proper use of public funds, so that they are disbursed in accordance with rigorously set subscription prices; and from that of the institution itself and of the "interested parties", because the market value will also determine the FROB's actual stake and, consequently, that of the former stakeholders in the resulting capital and in the institution's governing bodies.

On conclusion of this process, before 30 September 2011, the FROB will have taken a stake in the capital of these institutions and will vote on the decisions of their boards of directors on a scale proportionate to the economic valuation.

Thereafter, the FROB will participate directly in their management with the mission to monitor fulfilment of their business plans. It shall remain in the institutions only temporarily, and never any longer than the maximum term of five years in which the shares it holds must be disposed of to third parties through a competitive procedure.

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In sum, we are at the last stage of savings bank restructuring. The aim is that by 30 September the various steps outstanding should have been completed. This is the timeframe set by the Royal Decree-Law on the reinforcement of the financial system, although an exceptional three-month extension for operational reasons and a further three months in the event of an IPO would be possible.

In recent years our banking system has made a very intense balance-sheet write-down drive (equivalent to 9% of GDP in the three years from 2008 to 2010), it has evidenced unprecedented transparency in respect of its most problematic exposures, and it has recapitalised drawing on private funds and also with relatively limited public aid when compared with other countries. In turn, Spanish legislation has risen to the challenges posed by the crisis with a raft of measures. These include most notably, due to their intended durability, the establishment of new solvency requirements, the modernisation of the legal regime governing savings banks and the creation of more flexible and efficient banking crisis-resolution instruments.

We trust we will move into autumn with all our homework completed.

Thank you very much.

