BANCO DE ESPAÑA
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ASSESSMENT OF THE STRESS TESTS

Maximum transparency: all Spanish listed banks and all Spanish savings banks have been tested, and highly detailed information provided

The results of the stress tests of 91 European credit institutions are published today. The test scenarios and methodology have been developed in a coordinated fashion by the Committee of European Banking Supervisors (CEBS) and the European Central Bank (ECB).

The commitment made at the European level was that the participating institutions of each country should represent at least 50% of the banking sector. With the aim of increasing transparency in respect of the Spanish banking sector, stress tests have been conducted for all listed banks and for all savings banks, accounting for practically 100% of the total assets of Spanish banks and 100% of the total assets of savings banks.

Additional and detailed bank-by-bank information is provided of both hypothetical losses on different books and on the capitalisation support which had been committed prior to the stress tests being conducted.

The stress tests determine the capital needed in a highly stressed and unlikely scenario

Stress tests assess the extent to which institutions are capable of withstanding a highly adverse macroeconomic scenario over a specific period of time. The scenario chosen, on the basis of its adversity, is not a projection or estimate of either developments in the economy or of institutions' results and capital. A very-low-probability assumption is used, since the aim is to ensure that institutions have sufficient capital to withstand an adverse and highly unlikely scenario. This ensures that the banking system is solvent, including in extreme circumstances.

The stress tests comprise several elements: the benchmark and adverse macroeconomic scenario, hypothetical impairment losses in this scenario, institutions' resources to absorb such hypothetical losses, including, where necessary, additional capital needs, and finally a benchmark capital ratio that institutions should maintain in the most adverse scenario.

CEBS has defined a Tier 1 capital ratio of 6% to be maintained in the adverse scenario, which is 50% higher than the legally required minimum

The benchmark level of capital selected is a Tier 1 ratio of 6%, 50% higher than the legally required minimum (and, moreover, in a scenario that is stressed relative to the real situation). The sole precedent in this connection is the process (SCAP) conducted by the US supervisory authorities a year ago, in which a Tier 1 ratio of 6% and a core capital ratio of 4% were set. In the case of Spanish banks, and in particular of savings banks, the distance between Tier 1 and core capital is usually around 1.5 percentage points.

The adverse macroeconomic scenario for Spain is severe (cumulative decline of 2.6 percentage points of GDP in 2010-2011) outside the current forecast ranges, and is in addition to the strong contraction of the economy in 2009

Two macroeconomic scenarios have been considered by the European authorities: a benchmark scenario and an adverse scenario, the latter being used to determine additional capital needs, where necessary.

- Stressed benchmark scenario. While this is based on the central scenario of macroeconomic variables, it incorporates stressed assumptions on the parameters that intervene in the calculation of impairment losses and in the resources available to absorb them. It is not therefore a plausible estimate of developments in the Spanish banking system in 2010 and 2011, but an exercise of resilience in clearly difficult - but not extreme - circumstances.

- Stressed adverse scenario. The high degree of stress translates into a cumulative decline in GDP in 2010-2011 of 2.6 percentage points, on top of the strong contraction in the Spanish economy in 2009 (-3.6%). This assumption of declining GDP is outside the current forecast ranges of the various national and international organisations and of market analysts.

Nominal declines of 28% in house prices and of 61% in land prices have been incorporated into the adverse scenario

Adding to the adverse macroeconomic scenario coordinated by the European authorities is the stress introduced into the parameters that determine potential impairment losses, which are consistent with respective declines of 28%, 50% and 61% in the prices of finished housing, housing under construction and land from their peak in the current cycle.

House prices in Spain behave in a specific way. Indeed, the cumulative decline in house prices in Spain to date, from their peak in the current cycle to the first quarter of 2010, has been 12% in real terms. And in recent quarters, signs of prices stabilising have been observed, with slight quarter-on-quarter declines. In fact, the structural characteristics of the mortgage market in Spain make this a sector which historically has posted the lowest default rates. For example, the default rate in 1993 was 4% compared to 8.5% for that of total credit to the resident private sector.

The hypothetical impairment losses are similar to those obtained in the US stress tests and higher than those actually observed in past banking crises

The hypothetical impairment losses assumed in the adverse scenario amount to €207,473 million: 7.3% of the overall portfolio for all the banks considered, and 9.5% for savings banks.

- This hypothetical impairment is in line with the theoretical exercises conducted by analysts and is similar to that yielded by the US SCAP. Setting the hypothetical impairment losses against risk-weighted assets, the result in the SCAP was 7.7%, compared with the figure of 12.6% assumed for Spanish savings banks.

- A broader historical perspective shows that hypothetical impairment as a percentage of risk-weighted assets for savings banks (12.6%, or 6.1% after taking net operating income and provisions into account) is higher than that actually observed in other significant bank crises: Finland (1990-93; 4.3%); Sweden and Norway (1990-93; 2.7%); Korea (1997-99; 11.6%).

Spanish institutions strove in 2008 in 2009 to restructure their balance sheets and strengthen their capital, and they have the capacity to generate recurring income

For each credit institution, the capacity to absorb hypothetical impairment losses expressed in the stressed scenario ultimately determines the projected impact on capital.

- Spanish institutions made very substantial write-downs during the last two years of the economic and financial crisis (2008 and 2009). This, and the strict Banco de España regulations on asset valuation and the setting aside of the attendant coverage, enabled them to build up a stock of specific provisions which, combined with the stock of general provisions still available in December 2009, absorb 34% of the gross impairment for the banking system as a whole (29% for savings banks). This is a substantial percentage since the provisions are calibrated to withstand expected business losses, and not hypothetical impairment losses in highly unlikely stressed scenarios.

- The capacity to absorb hypothetical losses through net operating income and capital gains verified by the supervisory authority is 48% of hypothetical impairment losses for all institutions (23% for savings banks). Spanish institutions' business model, based on traditional retail banking, generates a more stable and predictable income flow than other banking models, in which the weight of income arising on more volatile market trading and investment banking activities is greater. However, for the purposes of the stress tests, the average net operating income for the period has been stressed, which in the case of the savings banks has meant that a 40% decline has been assumed in relation to the figure recorded in 2009. This figure, moreover, does not envisage the positive effects of the reduction in costs already embarked upon by institutions in the past two years. In historical terms, this means that the ratio of net operating income to total assets would be 37% lower than the average ratio recorded in the last 20 years. Note that in the US stress tests, a net operating income ratio 15% lower than the average ratio of the past 20 years was considered.

- During 2008 and 2009, institutions also strengthened their capital (by issuing equity and capitalising profits). As regards savings banks, their restructuring has taken place through integration processes. This eases the need for additional capital that might arise since, given the design of the processes, the outcome is that the excess capital at certain institutions relative to the minimum required levels offsets the greater capital shortfalls that other institutions might have.

The results show the soundness of the Spanish banking sector

The comparison of hypothetical impairment losses with resources available to absorb them determines the additional capital in order to meet, as defined by CEBS, a Tier 1 ratio of 6%.

- No private bank needs more capital to reach a Tier 1 ratio of 6% in the adverse and unlikely scenario.

- The Banco de España has undertaken an intensive savings bank restructuring process over the past year. This reorganisation, which has completely changed the landscape of the savings bank sector, has been by means of integration processes that provide the resulting groups of savings banks with greater size and efficiency, while reducing the system's capacity. So that the process may unfold in an orderly fashion, when support has been requested from the FROB, specific and verifiable integration plans of the institutions involved have been required, while it has committed resources in the form of capital for an amount of €10,583 million.

- The total capital needed for savings banks amounts to €16,193 million. Of this figure, €14,358 million (adding €3,775 million from the Deposit Guarantee Fund to the €10,583 million provided by the FROB) were committed and approved by the authorities before the stress tests.

- Accordingly, to comply with the Ecofin resolution that no bank subject to the stress tests be left with a Tier 1 ratio of less than 6% in the hypothetical adverse scenario, €1,835 million have been added at four institutions. The additional needs for capital arise at four groups of savings banks, although their capital ratios currently exceed the Tier 1 ratio of 6% comfortably.

The recapitalisation of those savings banks that have required it during the sectoral restructuring process does not entail a non-returnable cost for the public coffers

The cost in terms of public funds, through the FROB, of the recapitalisation undertaken in the savings bank sector has committed €392 million for Cajasur and €10,191 million in the form of convertible preference shares. This amount accounts for 1% of GDP and is not non-returnable; rather, institutions that have received funds from the FROB in the form of preference shares will have to return them within a period of five years at a cost for these institutions of 7.75% (APR 8.05%).

Also, looking ahead, the new savings bank legislation allows these institutions to raise core capital on the market. Hence, if in future savings banks needed more capital, they could recapitalise by resorting, as banks have done, to the market.