09.05.2013

Note on the *Financial Stability Report*: loan refinancing and contrasting of the stress test conducted by Oliver Wyman in 2012

The May 2013 *Financial Stability Report* (FSR) recently published by the Banco de España provides, for the first time, quantitative information on the Spanish financial system's refinanced and rescheduled loans. It also includes a retrospective and prospective analysis of the results of the stress test conducted by Oliver Wyman, comparing the data observed up to December 2012.

Broadly, the FSR shows that the Spanish banking sector, now the uncertainty over the valuations of a portion of its assets has been dispelled and bearing in mind its restructuring and recapitalisation, is faced with a scenario in which there is a continuing and substantial degree of uncertainty on financial markets and weakness in the real economy. However, the progress made in restructuring and recapitalising the banking sector, including the sizable volume of provisions built up in 2012 and the transfer of real estate assets to Sareb, have left the sector better placed to tackle these difficulties and restore the confidence of the financial markets. The ability of the euro area Member States to address budgetary and structural measures domestically and to push through reforms for the area as a whole, most notably in the Banking Union project, will be key to bringing the euro area financial markets back onto a more normal footing.

With regard to refinanced and rescheduled loans, this is the first time detailed information has been published on them. Such data first began to be demanded of banks further to Banco De España Circular 6/2012, which obliges each bank to publish loan refinancing and rescheduling figures, thus making Spain the first European Union country whose banking system has to comply with this transparency requirement. The aggregate data published by the FSR[1] show that refinanced and rescheduled loans, totalling €208.21 billion, account for 13.6% of total credit to the resident private sector. Segment by segment, 33% relates to construction and real estate development companies; 36.2% to other companies; 24.4% to mortgages; and 5.3% to other household loans. The remaining 1.1% corresponds to general government. 20.6% of the total (€42.93 billion) is classified as substandard (with coverage through provisions of 18.4%) and 37% (€77.06 billion) as doubtful (with coverage of 40.6%). Refinancing and rescheduling to construction and real estate development firms classified as standard are also subject to coverage through provisions, as stipulated in Royal Decree-Law 18/2012 to cover standard exposures linked

[1] Page 31 of the FSR.

to the real estate sector. There is some dispersion across banks, which may be indicative of different business and risk-management models, but also of differences in accounting practices. Owing to this latter possibility, on 30 April the Banco de España approved a letter to be sent to banks detailing the criteria on loan refinancing and rescheduling in Circular 4/2004.

Banks will be bound to review the accounting classification of refinanced or rescheduled loans to ensure compliance with these criteria, informing the Banco de España of the outcome of this review and of the related accounting effects before 30 September 2013.

Further, seven months after the publication of the results of the bank-by-bank (or bottom-up) stress test conducted by Oliver Wyman, it is now possible to compare these results with actual developments in 2012. As regards probabilities of default, those observed have been lower than those estimated by the consultant, both in the baseline and in the adverse scenario, in four of the six portfolios: real estate development, mortgages, SMEs and consumer credit. In the large corporations and public works portfolios, actual defaults in 2012 are somewhat higher than those estimated for the baseline scenario, although they are still far removed from the estimates for the adverse scenario. Likewise, the 2012 figures show profit before provisions higher than the estimates made by the external consultant, for that same year, in the two scenarios considered.

As regards the economic fundamentals, GDP and interest rates have performed better than assumed for the Oliver Wyman baseline and adverse scenarios, although the unemployment rate and the fall in house prices are closer to the estimates under the adverse scenario. Bearing this in mind, a prospective exercise was conducted combining the external consultant's modelling of probability of default estimates and the projections for the Spanish economy (recently published by the Banco de España in its March *Economic Bulletin*). In all the portfolios except that of real estate development, the projections based on the Banco de España central scenario for this year and the next translate into cumulative probabilities of default higher than those estimated by the consultant in its baseline scenario, but still far removed from those under the adverse scenario. Furthermore, the current forecasts for the end-2013 core tier 1 ratio are positive, since all the groups identified in the Memorandum of Understanding exceed the 9% threshold set by at least 1 pp.