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Opening address

Conference: “New solvency requirements for Spanish banks”. Expansión

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Good morning,

Let me first thank the organisers and Expansión for inviting me to deliver the opening address at this conference, and Salvador Arancibia for his kind words of introduction.

We are now on the threshold of a new solvency framework for banks, endorsed by the Basel Committee, the international supervisors' forum that has been promoting best regulatory and supervisory practices in the sector for years.

In Spain's case, moreover, the sector must cross this threshold while addressing the intense **recapitalisation and restructuring process** with which it is responding to the commitments made under the Memorandum of Understanding (MoU) entered into by the Spanish and European authorities, and in which the IMF is participating as an observer. My intention today is to refer to this process and share with you some reflections on it.

As you know, our banking system has been hit in recent years by an unprecedented international financial crisis, by an economic crisis that has led our country to a double-dip recession and by the euro area sovereign debt crisis.

The setting is an admittedly adverse one, in which the **vulnerabilities that built up** during the long economic boom period in Spain have ultimately punished part of our banking system, which has been obliged in recent years to undertake a far-reaching restructuring and recapitalisation process, which is currently approaching completion.

Among these **vulnerabilities**, I would mention **four** in light of their significance: the accelerated growth of credit, with particular intensity in the real estate development segment; the alteration to the traditional financial equilibrium of bank balance sheets, with growing resort to wholesale - and largely international - funding markets; the oversizing and fragmentation of the sector; and weaknesses in savings bank governance arrangements, along with their limitations in raising top-quality capital.

Since 2008, a series of **measures** have been adopted in Spain aimed at alleviating or resolving the various **problems detected**: some focused on banks' liquidity, others on their capital, others on bolstering their efficiency and all of them in general on restoring confidence in the system. True, not all were as successful as intended, at least not to the extent that would have been desirable. The weakness of the general macroeconomic environment has been one of the factors most contributing to slowing the effectiveness of these measures.

The first measures were geared to smoothing banks' access to financial resources, by means of the creation of the **Fund for the Acquisition of Financial Assets** and the implementation of the **public guarantee programme** for credit institutions' issues. A further aim was to safeguard the confidence of bank customers, raising the coverage provided by deposit guarantee funds to €100,000.

The following year saw the creation of the **Fund for the Orderly Restructuring of the Banking Sector (FROB)**. Its functions were twofold: to set in place a resolution framework complementing that of the deposit guarantee funds, and one more flexible in its operation and with greater financial capacity; and to lend capital in the form of State aid for bank mergers. The result was a rapid process of concentration in the savings bank sector, in which the number of institutions or groups fell in a very short time from 45 to 17.

The most significant **savings bank** reform was in **2010**. This opened the way for them to pursue their **activity** through a **banking subsidiary**, a possibility which in practice spread rapidly.

One year later, the **first qualitative leap** in Spanish **solvency regulations** was taken: a new minimum core capital ratio of 8% (10% at unlisted banks more exposed to wholesale markets) was established. The new ratio went far beyond the harmonised solvency regulations at the European level. Banks that did not meet the capital levels required and which were not capable of raising new funds privately could count on the **support of the FROB**, which was able following the reform to lend funds by taking a stake in the banks.

Yet these measures did not succeed in dispelling all the uncertainties over the soundness of a segment of the Spanish banking system. The macroeconomic downturn and the heightening of the sovereign debt crisis increased doubts over the quality of construction and real estate development-related assets.

In the first half of this year, to restore confidence and ensure a prudent and standardised valuation of these assets, substantial regulatory measures were adopted through the approval of two **Royal Decree-Laws imposing new minimum provisions**, not only for impaired lending in these segments but also for standard loans, in order to take into account potential cross-portfolio migrations.

Finally, to conclude this introductory section, the Government decided last May to commission an independent evaluation of the degree of solvency and of the business outlook for the Spanish banking system as a whole, and on 25 June it requested **external financial assistance from the Eurogroup** under the recapitalisation and restructuring process of the banking sector.

This request gave rise to the negotiation and signing of the **Memorandum of Understanding (MoU)** on financial sector policy conditionality, on 20 July. The MoU sets out a clear roadmap for the recapitalisation and restructuring of the most vulnerable part of the Spanish banking sector. I shall talk first about the implications of the stress tests, next about bank recapitalisation and restructuring, and finally about the transfer of the impaired assets, thus addressing the three core aspects of the MoU.

The **first milestone** of the MoU was the **estimation** of the banking system's **capital needs** and the exhaustive review of the quality of bank balance sheet assets.

To do this, a comprehensive analysis of bank asset quality and a bottom-up stress test under a highly adverse and very unlikely hypothetical macroeconomic scenario were conducted.

The main Spanish groups, accounting for around 90% of our system's assets, participated in this complex exercise, which began in late May and ended on 28 September.

The exercise comprised **2 stages**: first, a **top-down** analysis in which the recapitalisation needs for the Spanish banking system as a whole were determined, amounting to between €16 billion and €26 billion under the baseline scenario and between €51 billion and €62 billion under the adverse scenario; and second, a **bottom-up** bank-by-bank analysis, as a natural extension of the previous work, enabling the capital requirements for each individual bank to be determined. The results confirmed the conclusions of the top-down test, placing capital needs at €25.9 billion for the more likely scenario and at €55.9 billion for the adverse scenario.

Unquestionably, the **exercise** was a highly **rigorous** one for various reasons.

Firstly, because of the **harshness of the macroeconomic scenario** used in the adverse scenario, which envisaged, for instance, a 6.5% cumulative decline in GDP for the period 2012-2014 and respective nominal cumulative declines in house prices and in land of 25% and over 60% from 2011. The working hypotheses considered were also harsh, including high probabilities of default (PD) and expected losses (by way of example, a cumulative PD of 88% was estimated for the real estate development segment under the adverse scenario), and severe adjustments to the business plans submitted by the banks.

Secondly, it should be stressed that the valuation was conducted by **independent specialists**: two international consultancies, the four main audit firms in Spain, six national and international real estate appraisal companies, and a project lead-manager. The entire project was supported and coordinated by the Banco de España.

The **audit firms** verified, firstly, the quality of the data, with lower reclassification levels than the hypotheses adopted in the top-down exercise; secondly, they ensured that the provisioning shortfall was not material for the system as a whole, but concentrated mostly in the real estate development portfolio, and that it will be covered by the provisions required under Royal Decree-Laws 2 and 18/2012; and thirdly, they verified that the sample analysed showed low levels of refinancing which were not marked in the SME and retail segments (3% and 1%, respectively) and which were higher in the estate development sector (21%).

Finally, a comment on the **governance of the exercise**; in addition to the national authorities (Banco de España, Ministry of Economy and Competitiveness, and the FROB),

representatives from the European Commission, the European Central Bank, the European Banking Authority and the International Monetary Fund all participated.

The **main results** are well-known. Under the adverse scenario:

- **Seven banking groups**, accounting for 62% of the credit portfolio analysed, **will not require** any additional **capital**. Among these are Spain's three biggest groups, which evidenced ample solvency under the adverse scenario.
- The four banks in which the **FROB** has a stake **concentrate** 86% of the sector's capital needs.
- For the remaining institutions (6), the need for and amount of State aid will be determined further to the analysis of the plans these banks have already submitted, a decision on which will be adopted before the end of the year.
- We can currently state, based on the study of the recapitalisation plans submitted, that two of these institutions, **Banco Popular and Ibercaja**, will, if they see their plans through successfully, cover **capital needs through their own means**, following the terms envisaged in the MoU, by end-2012. The **remaining banks** - Banco Mare Nostrum, Caja3, Ceiss and Liberbank - are expected to **resort to State aid** as part of their recapitalisation processes, including hereunder the transfer of assets to the bad bank, the management of hybrid instruments and, if necessary, financial support from the FROB via capital or via contingent convertible bonds (CoCos).

Significantly, the capital needs of €55.9 billion resulting from the exercise, which are far below the €100 billion of European financial assistance agreed by the Eurogroup, will not be the **final figure of State aid** that banks will receive. The figure **will be substantially lower**, following the examination of the recapitalisation plans and the adoption by banks of the possible measures envisaged in the MoU.

The **second** significant **milestone** in relation to the MoU is the **recapitalisation, restructuring or resolution** of the most vulnerable banks identified in the stress test.

As stated, **since 2008 a series of measures** have been adopted, and reflected in specific decisions on certain banks: first, the taking under control in 2008 of Caja Castilla-La Mancha and its subsequent sale to Liberbank; the taking under control of CajaSur in 2009, this time by the FROB, and its sale to BBK; the granting in 2010 of State aid totalling around €9.7 billion, mainly through FROB preference shares, to certain banks; the administration by the FROB of two institutions, CAM and Banco de Valencia, in 2011, and the taking under control of another three, Catalunya Banc, Unnim and Novacaixa Galicia, with support of approximately €4.75

billion. CAM and UNNIM were subsequently sold to Banco de Sabadell and to BBVA, respectively.

Against this backdrop, the current phase of bank recapitalisation and restructuring is under way in Spain, under the agreements reached in the MoU and in the new regulations approved in August this year.

Under this new framework, the restructuring processes are applied to viable institutions in which it is foreseen that the public financial aid will be reimbursed, and to institutions whose resolution could not be carried out without seriously harmful effects for the stability of the financial system. The resolution processes are for non-viable banks where public interest and financial stability reasons make it necessary to avoid their winding up under bankruptcy.

These processes are based on the **principles** of viability, burden-sharing and limitation of the distortion of competition, in such a way as to promote financial stability and contribute to the improved efficiency of the sector.

In this way, the plans entailing the use of public funds will, first, give rise to restructuring that will depend on the scale of the aid; second, have to show that it is possible to ensure the long-term viability of the institution; third, have to be based on a significant cut in non-profitable activities, on the reduction of risk through the segregation of the most problematic assets, on the re-balancing of the funding structure, including less dependence on the ECB, on the improvement of governance and on the rationalisation of staffing and branches; and fourth, have to detail measures to reduce to a minimum the burden on taxpayers and to ensure the greatest possible absorption of the losses on capital and hybrid instruments.

I should reiterate that the estimated capital needs do not coincide with the volume of public funds finally required, since we must discount the impact of the transfer of impaired assets to Sareb, the effect of the carrying out of loss-absorption exercises by the holders of hybrid or subordinated instruments and any other measure envisaged in banks' restructuring plans.

The restructuring or resolution **plans** of the banks controlled by the **FROB**, namely those in Group 1, will be approved in the coming days, before the end of November. Indeed, the processes for the sell-off of Banco de Valencia and Catalunya Banc, temporarily postponed in June, have now been re-launched.

Following the approval of plans, and once the attendant agreed measures have been adopted, State aid will be granted. **The transfer of European funds** to the FROB for these institutions (which account for the bulk of the needs) **will take place in the first half of December**. The FROB will then inject the respective funds into the banks concerned, once the pertinent mercantile or administrative steps have been taken. For the remaining banks requiring State aid, the approval of the restructuring plans will be in December.

I would like to underscore the efforts made by all concerned in the process to date, namely consultants, banks, auditors, appraisers, the Banco de España and the other national and international authorities, to ensure there have been **no delays in the schedule set out**.

Lastly, the instrument which will see the completion of the MoU process is the **segregation and transfer of the impaired assets to an external asset management company**.

Last Thursday marked the approval of the Royal Decree which finalised the legal framework for the Asset Management Company for Assets Arising from Bank Restructuring, known as Sareb. A Chairwoman and General Manager have already been designated for Sareb, a decision pending ratification by the Board of Directors of the company. We expect the company to be operational in December, when the transfer of the problem assets of the banks currently controlled by the FROB will begin.

Further ahead, it will be necessary to tackle the transfer of the assets of those banks which, according to their recapitalisation and restructuring plans, cannot obtain the capital they need through their own means and require State aid.

The **focus of this transfer of assets** will be on the risks related to construction and real estate development, both loans and investments and foreclosures, whatever their accounting classification. Minimum thresholds have been set (€100,000 for foreclosures, €250,000 for loans) to smooth the management of Sareb and to avoid an excessive number of assets with a relatively small unit value.

The asset **transfer price** will be determined by the Banco de España, according to the European authorities, on the basis of two components:

- On one hand, the **economic value** of the assets in the baseline scenario, which is drawn from the report by Oliver Wyman further to last summer's stress test.
- On the other, **haircuts** to this value to take into consideration aspects such as coverage of the risk of unfavourable price developments, the expenses and costs resulting from holding the assets or the very prospect of divestment.

The resulting values of these adjustments account approximately for a discount of 63% on the gross book value of foreclosures and of 46% on loans.

Importantly, these transfer **prices** are **not a benchmark** for the **valuation of non-transferred bank assets**, precisely because the transfer prices are influenced by aspects such as the en-bloc sale of assets, which should not be equated with their unit sale value, or, as earlier indicated, because expenditure projection adjustments have been introduced that will now have to be borne by Sareb and which, until the time of the transfer, had been borne year by year, month by month, by the banks' profit and loss accounts.

The legal **maximum size** of Sareb's balance sheet is €90 billion. However, it is estimated that the volume of assets to be transferred corresponding to the banks controlled by the FROB will amount to around €45 billion.

If we take into account the assets to be transferred in a second phase from the other banks with capital needs, the size may be close to €60 billion, but in any event lower than the limit.

Sareb will have various sources of **financing**. The main one will be State-backed bond issues, which will be subscribed by the banks that transfer assets, as payment for the bonds. For its regular functioning, Sareb will have its capital, at least 50% of which will be in the hands of private investors, and subordinated debt.

A preliminary **business plan** with a 15-year horizon (the maximum duration of the company) has been drawn up, and must be ratified by the Board of Directors of the company. The plan takes into account the Spanish economy's macroeconomic and financial setting and the real estate market in particular, and bears in mind aspects such as the market absorption capacity of each type of asset or the region in which it is located.

Consequently, **Sareb is conceived as a profitable venture**, with a business plan that estimates a return on equity (RoE) of around 14-15% under a conservative scenario. Evidently, these estimates are derived from the horizon over which the plan is envisaged, which is a very long-term one (15 years, the maximum foreseen duration).

Sareb will have a fairly lightweight organisational structure relative to its size, based on the externalisation of management and administrative functions. As to its **governing bodies**, these will be those established for public limited companies, with certain particularities, relating to the make-up of the Board of Directors, and to the existence and composition of the Audit Committee, the Remuneration Committee and other support committees.

Of note, in view of its singularity, is the existence of a **Monitoring Committee**. This lies outside the structure of Sareb, comprises four parties (Ministry of Economy and Competitiveness, Ministry of Finance, Banco de España and CNMV) and exists to oversee compliance with the general objectives for which the company is set up. National or international public institutions may take a seat on this committee as observers.

To conclude this section on the MoU, allow me to say that it not only sets specific conditions for credit institutions requiring State aid; it also includes **horizontal conditions** for the sector as a whole that are likewise running to schedule. These include most notably a core capital ratio of 9% and the reform of resolution regulations.

In sum, I believe the **measures highlighted will most certainly contribute to dispelling uncertainty over the most vulnerable part of the banking sector**, which will reinforce the soundness of the financial system and its capacity to extend credit and promote growth and

employment. Indeed, at the core of the Spanish banking and financial sector are sound and well-capitalised institutions capable of withstanding highly adverse scenarios.

We are thus drawing closer to the point where all banks that need it will have been restructured, recapitalised or resolved. And the banks that, on the way, have needed State aid owing to their vulnerability to withstand potentially adverse scenarios will have unburdened their balance sheets of the bulk of real estate development and construction risk.

Our **banking system** in its entirety will be ready to face a **still-complex future** and to comply with its vital function of efficiently channelling the economy's financial resources. The system will have to adapt to the new competitive conditions set in place by the ongoing concentration of the sector, to the new scale of real flows in the post-crisis economy, to the harsher external conditions for achieving efficiency and to the domestic difficulties that any restructuring of business or integration of institutions entails.

The aim is that none of these challenges should henceforth pose any obstacle to our system providing the economy with all the solvent credit it may need.

Spanish credit institutions face this challenge and, like all their European counterparts, they are also **challenged** with **accommodating the new solvency requirements derived from Basel III**, which I shall now briefly **mention**.

As you will know, in July 2011 the European Commission presented its **draft Directive and Regulation to replace the current capital requirements Directives**, providing for the transposition into European Union law of the new framework for capital requirements known as Basel III. Since then, months of arduous negotiations have passed in which different national stances and even differing views on both pieces of legislation on the part of the EU Council and the European Parliament have progressively drawn closer on several points. However, a compromise has not yet been reached that can be presented and approved at the Ecofin in early December.

Yet there is a political compromise by all the parties involved to reach this proposal by the end of November, and to achieve the objective whereby this new European regulation may come into force on 1 January 2013. This is of vital importance if the Banking Union, and more specifically the Single Supervisory Mechanism, which I shall talk about later, is to be promptly set in train. Its effectiveness requires an applicable, common regulatory framework without having to resort to the transposition of the directives in the different national jurisdictions.

In any event, without prejudice to the recapitalisation plans I have referred to earlier, **Spanish banks are well placed to face the new requirements arising from this new European regulation**. It should not be forgotten that new capital requirements (a core capital ratio) were already introduced in 2011 that involved a substantial approximation to the new Basel III

framework, whose level of stringency was largely anticipated in respect of the timetable for the implementation of this framework.

However, further to the conditions agreed with the international authorities in the MoU, Royal Decree-Law 24/2012 approved last August, and recently reformed as Law 9/2012, has led to the revision of the regulations on this core capital ratio, using the definition laid down by the European Banking Authority (EBA). This draws the definition even closer to that of the Basel III capital requirements, setting the level of compliance required from 1 January 2013 at 9% of risk-weighted assets.

With this level of 9%, Spanish credit institutions will have no difficulty addressing compliance with the capital requirements demanded in 2013 as a result of the entry into force of the new European regulations, and they will indeed be quite ahead in the phasing in of the new capital requirements, for which they have until January 2019.

I should not wish to conclude without referring to the work of the Banco de España as a supervisory authority. Here, too, changes arising from our commitments within the euro area are being debated. On 12 September the European Commission published a legislative proposal to confer upon the **European Central Bank** the bulk of **euro area banking supervision**. This proposal is in response to the conviction that the architecture of the economic and monetary union needs to be strengthened to break the vicious circle between banking risk and sovereign risk in certain euro area Member States and to reverse the current process of fragmentation of euro area financial markets.

Establishing the so-called Single Supervisory Mechanism will contribute, along with other measures such as those already taken in Spain, to restoring confidence in the banking sector and to re-activating interbank loans and cross-border credit flows. Here, **headway must be made in designing integrated supervision** for all the euro area members, on the basis of a system that entrusts the ECB with supervisory powers and which, in turn, harnesses the experience and knowledge of national supervisors. For the overall consistency of the new framework, relevant issues such as resolution processes and Europe-wide depositor protection arrangements must later be addressed.

To conclude, I will say that we are at a **complex and demanding stage** in which we are doing everything necessary to construct a strong and solvent financial system. We are aware that major work still lies ahead, but we are in turn convinced that we are moving in the right direction. We will spare no effort in the process.

Thank you for your attention and patience.