BANCO DE ESPAÑA
Eurosistema

15.11.2012

Reform of the Spanish banking sector: measures to reinforce financial stability

Santander Central Bankers Seminar/Banco Santander

Fernando Restoy
Deputy Governor

---

1 Introduction

I am very pleased to participate in this International Banking Conference organised by Banco Santander. As you all know, the Spanish banking system is in the midst of an unprecedented restructuring and recapitalisation process. Important steps forward have already been taken and we expect that the whole process will be completed in a few months. I think that **this event is an excellent opportunity to review what has been done so far and to discuss the main challenges that remain ahead**.

2 Initial measures to reinforce confidence in the Spanish banking sector: 2008 to mid-2012

The major **problems of the Spanish banking sector are rooted in the imbalances that built up in the long period of expansion** preceding the financial crisis. During this period, lending to the private sector, and particularly to construction and real estate development activities, grew very strongly. This credit growth could not be fully funded through retail deposits and therefore banks increasingly resorted to international wholesale and interbank markets. This increased the vulnerability of Spanish credit institutions to potential shocks in financial markets.

The significance of these vulnerabilities became evident during the course of the crisis. Accordingly, **between 2008 and 2011, the Spanish authorities adopted several policy measures**, which were broadly geared to supporting banks' liquidity, promoting the consolidation and restructuring of the more fragile institutions (notably, the savings banks), and increasing capital and provisioning levels, especially to cover risks arising from the real estate sector.

However, **these measures fell short of fully restoring confidence about the soundness of a segment of the Spanish banking system.** Indeed, perceived signs of vulnerability heightened in 2011 and early 2012, in light of the persistence of the uncertainty over the quality of construction and real estate development-related assets, Those signs emerged in a setting marked, moreover, by a downturn in macroeconomic prospects [-a double-dip-], by the prolongation and aggravation of the effects of the sovereign debt crisis and by the challenges faced by budgetary policy.

For this reason, **during the first half of 2012 important additional measures were adopted** in order to mitigate uncertainty regarding the valuation of assets related to construction and real estate development. In particular, in February and May, the Government approved two Royal Decree-Laws, which required **a significant increase in provisions** for impaired loans and foreclosed assets. In addition, measures were introduced to address concerns about performing assets by requesting that banks introduce a 30% general provision for the loan portfolio classified as standard, in order to take into account the potential migration from the normal to the problematic portfolio.

Overall, **the balance-sheet clean-up resulting from these measures entails a marked increase in provisions against potential additional losses** in the financial system. In

fact, when these measures are fully implemented, the provisions built up by the Spanish banking sector from 2007 to 2012 will amount to more than € 200 bn (around 20% of GDP).

3 The ongoing restructuring of the Spanish banking sector

These actions have contributed to improving the perception as to the situation of the Spanish financial sector. Yet further measures were required to address remaining market uncertainty. As a result, the Spanish authorities adopted two further important decisions:

- Firstly, in May, they decided to conduct an independent assessment of the solvency and business prospects of the Spanish banking system. In particular an exercise was performed to evaluate the resilience of the institutions in the face of an additional deterioration in the economy and to determine the level of capital that would ensure the long-term viability of banks.
- And secondly, in late June, authorities requested external financial assistance. The recapitalisation and restructuring of the banking sector required a public backstop to ensure that potential capital shortfalls would be covered. However, given the situation in sovereign debt markets, the perception was that creating such a backstop using only domestic resources could have further strengthened the links between sovereign and banking risks, hence aggravating the potential negative feedback loops between both sectors. Therefore, financial assistance of up to €100 billion was approved by the Eurogroup on 20 July 2012, as part of a Memorandum of Understanding (MoU) agreed by the Spanish and the European authorities, with the participation of the IMF.

The MoU comprises **both bank-specific conditions** for those institutions that need public-sector support **and horizontal requirements** that will apply to the banking sector as a whole and to the regulatory and supervisory framework. The ultimate goal of this agreement is to strengthen the resilience of our banking system and to build the trust needed to normalise access to international funding markets.

The Memorandum of Understanding establishes a clear roadmap for the recapitalisation and restructuring of the Spanish banking system. The key component of the programme is the r**eview of the more vulnerable segments of the banking sector, which has three major elements**:

- Firstly, the **identification of individual bank capital needs** through a comprehensive asset quality review of the banking sector and a bank-by-bank stress test, conducted by an independent external consultant.
- Secondly, **the recapitalisation, restructuring and/or resolution of the least viable banks**, based on plans to address capital shortfalls identified in the stress test.
- And finally, **the segregation of impaired assets** in those banks receiving public support for their recapitalisation and their transfer to an **external Asset Management Company.**

These three elements constitute the core of the strategy we are pursuing to conclusively restore confidence about the soundness of the whole Spanish banking system. Let me elaborate on the latest developments in these three areas.

3.1 Asset quality review and stress tests

The first stage of this process was the assessment of the capital needs of Spanish banks, which has been carried out in two steps. The first one was **a top-down stress test**. The results of this exercise, published in late June, showed that, as an initial approximation, the Spanish banking system might need between €51 bn and €62 bn to maintain a 6% core capital ratio in a very stressed macroeconomic scenario. **This exercise helped to delimit the magnitude of potential capital needs of the overall system**, which were estimated to be well **within the envelope of the €100 bn backstop** agreed with European authorities.

Moreover, this top-down exercise also provided an indication of the distribution of capital needs among broad categories of institutions. In particular, the results showed that **the bulk of the capital deficit was concentrated in a group of 4 institutions** in which the Spanish Fund for the Orderly Restructuring of the Banking Sector (FROB) already had a stake. **Moreover, the exercise showed that the largest banking groups would not need additional capital** even under a highly adverse scenario. Yet while the information used in this exercise allowed us to obtain a reasonable estimate of capital needs for the banking system as a whole, it was not granular enough to provide reliable individual bank-by-bank estimates.

Therefore, after completing this top-down exercise, **a bottom-up analysis was conducted** from early July to end-September. This analysis involved, as a first step, a comprehensive due diligence review and detailed analysis of specific bank portfolios. The results of this preliminary work were then used as an input for a second round of stress-test exercises **to determine bank-specific capital needs**.

To ensure the consistency with the top-down exercise conducted in June, the same macroeconomic scenarios were used and the exercise was applied to the same set of credit institutions, comprising **17 banking groups that account for around 90% of the Spanish banking system.**

I would like to **stress three characteristics of the exercise which illustrate the rigour with which it was performed**:

- Firstly, the **exhaustiveness of the information used.** The exercise was conducted by the consultancy firm Oliver Wyman, which had access to granular loan-by-loan data from databases available at the banks and at the Banco de España, as well as to the business plans of each banking group. In addition, the four major audit firms verified the quality of the data on the loan portfolio and foreclosed assets, and the adequacy of accounting classification and provisioning levels. Finally, six national and international appraisal companies reviewed the valuation of real estate-related assets.

- Secondly, **both the scenarios and the assumptions considered are very conservative**. For instance, the adverse scenario envisages a harsh 6.5% cumulative decline in GDP over 3 years. Moreover, the probabilities of default considered in the adverse scenario were remarkably high, amounting up to five times the current default rates for some portfolios. In addition, in that scenario, a 64% loss for foreclosed assets was assumed.
- Finally, to ensure the quality and the consistent application of the methodology, **a strong governance system was established** to supervise the exercise. Two committees, made up of experts and officials from national and international authorities, were responsible for adopting the main strategic decisions and monitoring the work. In addition to the Spanish authorities, the European Commission, the European Central Bank (ECB), the European Banking Authority (EBA) and the International Monetary Fund (IMF) participated very actively in the work of these committees.

The **results of the bottom-up exercise** were presented on September 28**.** They show that in the most likely scenario -the baseline scenario- only banks in which the FROB already had a stake would require a significant amount of additional capital to meet the minimum required[1] of 9% core Tier -1.

In the adverse scenario, **7 banking groups, accounting for 62% of the credit portfolio analysed, would not require any additional capital**. For this group of banks, no additional measures will be required, although they are all making a significant provisioning effort in accordance with the requirements laid down in the Royal Decree-Laws approved in the first half of this year.

The rest of the institutions included in the exercise, which account for 38% of the loan portfolio, would need additional capital in the adverse scenario to meet the 6% minimum core tier 1 capital required. **The capital shortfall estimated for the system as a whole would amount to €59 bn**, without taking into account tax effects and the impact of ongoing integration processes. These capital needs are in line with those estimated in the previous top-down exercise conducted in June and clearly fall below the maximum backstop envisaged in the financial assistance programme.

It is important to point out that as much as 86% of the sector's capital needs in the adverse scenario are due to the 4 banks in which the FROB has a majority stake. For the remaining banks showing capital deficit, the need for State aid and, where necessary, the exact amount of this public-sector assistance will be determined after a detailed analysis of the recapitalisation and restructuring plans submitted by each institution.

Here it is important to note that **the State aid provided to banks will not coincide in general with capital shortfalls estimated in the stress test**. In particular, the need for assistance will be conditional upon several actions that institutions can undertake to reduce their final capital needs. In particular, institutions could dispose of assets or business lines; transfer them to the Asset Management Company; conduct burden-

[1] Minimum thresholds were set at 9% in the baseline scenario and 6% in the adverse scenario. These figures are in line with thresholds set in other countries.

sharing exercises involving the assumption of losses by holders of hybrid and subordinated debt instruments; or obtain new capital privately on the markets.

3.2 Restructuring and recapitalisation plans

Once the capital needs of each bank have been determined, the next step of the roadmap established in the MoU is the recapitalisation and restructuring of the weaker banks.

For those **institutions in which the Fund for the Orderly Restructuring of the Banking Sector (FROB) already had a capital holding** (Group 1 banks) the Spanish authorities have been working on the restructuring or resolution plans, in conjunction with the European Commission, since end-July 2012. We expect that the plans for these institutions should be **approved before end-November**.

The remaining institutions with a capital shortfall according to the stress test have recently submitted their recapitalisation plans. After a preliminary analysis, we have concluded, in agreement with the services of the European Commission, that **two of these institutions** (Banco Popular and Ibercaja) **should be able to meet their capital needs by their own** means by the end of December 2012. **The remaining 4 institutions are expected to resort to public suppor**t to meet their recapitalisation needs.

It is important to stress that **banks receiving State aid shall undertake a restructuring process, compatible with European rules on State aid**. These restructuring plans will be more demanding for those institutions with greater public assistance needs and they may entail requirements in terms of size adjustments, run-off of non-core activities or unprofitable business segments, rebalancing of funding structures, improvements in governance, rationalisation of branch networks and of staff levels, and burden-sharing exercises affecting holders of hybrid and subordinated instruments.

The restructuring plans for these institutions are expected to be approved before the end of the year. Support will be granted soon after the Banco de España and the Commission approve these plans. Once the operation has been agreed, the European Stability Mechanism (ESM) will transfer the funds to the FROB, which will subsequently inject them into banks to support its core capital.

3.3 Segregation of impaired assets

Finally, one of the main elements of the recapitalisation and restructuring process will be the segregation of impaired assets of institutions requiring State aid – assets mainly related to real estate – through their transfer to an external Asset Management Company (AMC).

Substantial steps have recently been taken in this regard. In particular, two pieces of legislation establishing the legal regime of the AMC, which will be named Sareb, will be approved shortly. The main features of this vehicle are the following.

Firstly, with regard to its **capital structure**, the Sareb will be designed so that the property will be mainly in the hands of private investors, while the Spanish authority (FROB) will have a non-majority holding. The own funds of Sareb, a portion of which may be in the form of subordinated bonds, will be approximately 8% of total assets. Significantly, banks

that transfer their assets will not be shareholders of the Sareb nor will they be represented on its board of directors. In exchange for the assets contributed, these banks will receive bonds issued by Sareb and guaranteed by the State.

In general, Sareb will have three main **sources of funding**: (i) issuance of State-guaranteed senior debt, which will be subscribed by banks transferring assets; (ii) perpetual subordinated debt and (iii) common equity.

Secondly, as regards the **perimeter of the AMC**, it will include foreclosed real estate assets whose net book value is over €100.000, loans to real estate developers with net book value exceeding €250.000 and controlling corporate holdings linked to the real estate sector.

We have also determined the maximum **size of the vehicle**, which will not exceed €90 bn. On the current information, the volume of assets to be transferred by the banks where the FROB has a majority holding is estimated to be €45 bn. This amount would increase to around €60 bn once the assets of other banks requiring State aid are transferred.

The **transfer value of these assets will be based on two different components.** Firstly, the real economic value of the assets, which will be determined using the detailed information and the expected losses in the baseline scenario used in the bottom-up stress test. Secondly, there will be additional downward adjustments, which will differ across asset types. These adjustments will be aimed at taking into account the very particular characteristics of this transaction, such as: the en bloc acquisition of assets; the consideration of management and administration costs of the assets to be transferred; the outlook for the timing of the divestment of the assets; and other factors related to the risks involved in the specific activity of Sareb. As a result of these singular adjustments, **the transfer price of assets to the Sareb is not a valid reference for the valuation of other bank assets which have not been transferred to Sareb**.

Therefore, **final transfer prices will be quite conservative** and will differ across different types of assets. **The average haircut with respect to gross book values will be 63% for foreclosed assets and 45.6% for loans**.

We have already prepared a provisional business plan for Sareb, which is currently being discussed with potential private investors. This business plan has been designed over a 15-year horizon and envisages macroeconomic and financial developments in the Spanish economy, particularly the real estate market. Taking into account this scenario, and considering the market's absorption capacity based on asset types and their geographical location, the company is expected to have an attractive return on equity in normal circumstances. However, given the economic prospects and the maturation horizon of this business, results could conceivably be rather modest over the first few years, when a large stock of assets has to be financed while sales still only represent a limited share of the stock.

Our expectation is that the AMC should be fully operational in December, when the first assets by Group 1 are expected to be transferred.

4 Next steps

To sum up, in the space of a few months there has been major progress in the restructuring of the Spanish banking sector and this process is expected to be completed shortly. What are the main steps ahead?

Regarding recapitalisation, we expect that the plans of Group 1 banks – i. e. institutions where the FROB has a majority holding – could be approved by the end of this month. As for the other institutions that will require public support, their plans will be approved in December. Therefore, we expect that funds required for the recapitalization of all institutions requiring State aid will be available before the end of this year.

Regarding the asset segregation process, we expect that new legislation will come into force rather soon. At this moment, recruitment of the management team is under way and the review of assets to be transferred by Group 1 (nationalised) banks has already started. The first assets will be transferred to Sareb in December and we expect that Group 2 banks' assets (banks that require recapitalisation with State aid) could be transferred in early 2013.

5 Conclusions

All in all, we have a clear roadmap for the restructuring and recapitalisation of the Spanish banking system, with well-defined milestones. Up to now, significant progress has been made, as recently acknowledged by the IMF and the European authorities. We are on track and by the end of this year the bulk of this process should be completed. I am confident that this will contribute markedly to strengthening confidence in the whole Spanish banking sector.

Thank you.