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The Financial Stability Report confirms that Spanish deposit institutions are facing the financial turbulence from a position of soundness

The sound performance of the banking business in the first half of 2007 combined with structural features of the Spanish banking model - the prevalence of traditional retail banking, the securitisation of assets without resorting to complex structures that segregate risk concession from risk management, and the high quality of securitised assets - provide Spanish institutions with a good starting point to face the turbulence on international financial markets. This is one of the conclusions of the Financial Stability Report published today by the Banco de España on its website, in which the period of turbulence generated by the US sub-prime mortgage crisis is analysed.

The Report indicates that it is premature to assess the true scope of this episode, as uncertainty continues to prevail over its potential impact on the global macroeconomic scenario, as well as over active risk management mechanisms and the implications of the so-called "originate-to-distribute" banking model. Under this model, credit is not managed by the institution until its maturity; rather, once it is granted, it is rapidly transferred to a third party to offload the risk and obtain fresh financing.

Spanish deposit institutions have not developed this model. Instead, traditional retail banking prevails, providing for a very close relationship with customers. Asset securitisation in Spain has thus not used complex structures, avoiding the adverse effects of separating risk concession and risk management. Moreover, the assets securitised are of a high quality. Covered bonds, as they are backed by institutions' entire mortgage portfolio, are also of a high quality.

It should be highlighted that there is no sub-prime mortgage segment in Spain and that Spanish institutions are not directly or indirectly (they have no vehicles or conduits) exposed to the US sub-prime market.

The market turbulence arose following a first half of the year in which credit slowed (it is growing at a rate of 22.6%), except in lending to industrial and services corporations, which will be conducive to a greater diversification of industrial portfolios. Further, the slowdown in credit, combined with the dynamics of deposits, suggests there will be lower borrowing requirements on the wholesale markets.

Doubtful assets have grown, but the doubtful assets ratios are at very low levels, as confirmed by the default rate curves. In the US sub-prime mortgage market, defaults stand at 15%. In Spain, defaults on individual mortgage loan transactions (0.5% in June 2007) reached a peak of 4% in 1993, at a time of recession not only far removed from the current conditions in our economy but also from the worst conceivable scenario.

The soundness of Spanish deposit institutions is discernible at several levels. First, there is the strength of their income statements, their profitability and their high efficiency. Second, solvency levels stand comfortably above the minimum regulatory requirements. And third, prudential regulations have specifically underscored the need for institutions to manage their credit risk appropriately. In this respect, the current turbulence highlights the importance of a general provisions model that contributes to generating the funds needed during expansionary phases, when risks originate, so as to withstand difficult times.

In June 2007, provisioning for bad debts covered somewhat over 2.5 times the doubtful assets of Spanish deposit institutions. If, moreover, regard is had to the high level of debt recovery observed in Spain in the event of default, especially in lending to households for house purchases, the current levels of provisioning for bad debts could absorb at least fivefold growth in the current levels of default, without significantly impacting deposit institutions' results.

Finally, institutions' resilience is also apparent through the stress exercises performed both on the income statement and on the distribution of credit risk losses.

The full text of the Financial Stability Report is available at:
http://www.bde.es/informes/be/estfin/completo/estfin13e.pdf

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