Reform of the Spanish banking sector: implications and remaining challenges

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Recent reforms are having a large impact on the Spanish financial sector, but their ability to address pending challenge –the clean-up of balance sheets– will depend also on macroeconomic conditions

Over the past few years, the Spanish banking sector, an in particular the savings banks sector, has undergone a period of profound, historical change. Underpinned by a series of regulatory measures, Spanish financial sector reform set out to: foster sector reorganization to promote increased efficiency, change the legal framework governing the savings banks regimes, strengthen the sector's capital ratios in line with new global requirements, and increase confidence through increased provisioning requirements related to real estate assets. At the same time, new incentives for further consolidation were introduced last February. Measurable results thus far demonstrate substantial progress. However, outstanding doubts remain regarding the adequacy of current levels of provisions, and whether the latest round of reforms will catalyse the necessary further downward adjustment to Spanish housing market prices. Reform efforts must continue. At the same time, it will be important to maintain some of the particular characteristics of the Spanish savings banking model, which has demonstrated benefits at the national level over the past 40 years. high degree of uncertainty.

Spain's unique approach to Banking Sector reform in the EU context.

Since 2009, the Spanish banking sector has undergone some of the most ambitious and intense reforms since the financial liberalization of the 1970s and 1980s. These reforms have essentially been implemented through the approval of four major regulatory measures. The first one was the Royal Decree-law 9/2009, creating the Fund for the Orderly Restructuring of the Banking Sector (FROB). The second was the Royal Decree-law 11/2010, improving governance and others aspects of the legal framework of the savings banks. The third was the Royal Decree-law 2/2011, for the reinforcement and recapitalisation of the financial system. The fourth and most recent has been the Royal Decree-law 2/2012, increasing the provisioning requirements related to impaired assets.

While recent regulatory action has mainly focused on restructuring the sector and, lately, the clean-up of banks' balance sheets, there has been – at least at certain stages of this reform process - a special focus on savings banks. This article surveys the main contents of these regulations and focuses on two issues in particular:

i) The effects of the reform on savings banks' legal and competitive structure.

ii) The recent developments following the RD-l 2/2012 and the remaining challenges.

It is important to note that Spain has followed a very unique path compared to other European countries where the reform of the banking sector is concerned. In particular, when many EU countries

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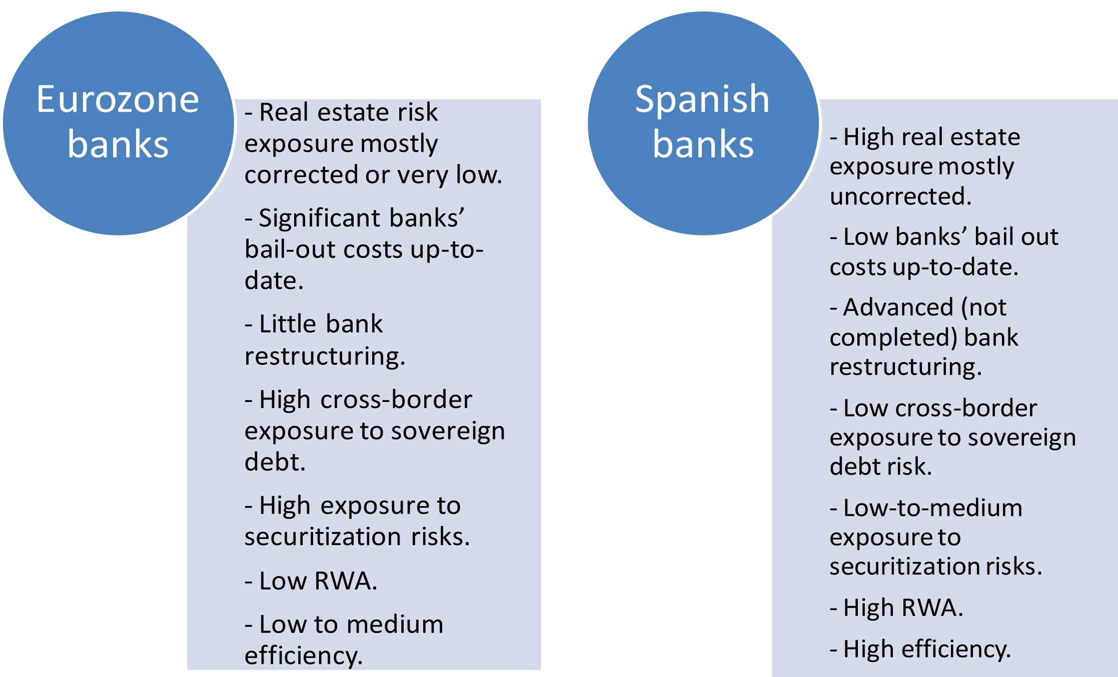
undertook significant bank recapitalizations after the Lehman Brothers collapse in 2008, Spanish authorities did not carry out any bank capital injections at that time. The main reason was that the Spanish banking sector had shown more resilience to contagion from special purpose investment vehicles linked to US subprime mortgages. The Bank of Spain had prevented Spanish banks from involvement in these types of vehicles in the years prior to the crisis. On top of that, the Bank of Spain had imposed countercyclical provisions in 2001 that helped Spanish banks mitigate the early impact on the crisis on their balance sheets. However, in 2009, the solvency concerns related to the Spanish banking sector's significant exposure to impaired real estate assets, together with the need to reduce excess capacity in line with the new economic reality, needed to be addressed. The first such response was the abovementioned RD-l 9/2009. Therefore, while the focus in other European countries was at that time on recapitalization (with almost no restructuring of the banking sector to date), in Spain, the primary objective was to undertake bank restructuring first and subsequently, bank recapitalization and the clean-up of impaired assets.

> *In 2009, the solvency concerns related to the Spanish Banking sector's significant exposure to impaired real estate assets and the need to reduce excess capacity, needed to be addressed*

There are some other differences between the Spanish banking sector and those of Eurozone countries that help explain the remaining regulatory challenges. As shown in Exhibit 1, the main problem of the Spanish banks is their exposure to real estate assets, which is very large compared to most Eurozone countries. This is a key distinctive feature that makes the problem of Spanish banks more visible and explicit. It has also been the main source of concern among international investors and analysts. However, the majority of impaired assets on the balance

Exhibit 1: Eurozone banks vs. Spanish banks: main structural differences and regulatory treatment



Source: authors' elaboration.

sheets of other Eurozone countries' banks appear largely in the form of securitization and sovereign debt exposure, which are somewhat less transparent. Therefore, they have a smaller negative signalling effect than in the case of Spain.

The difference in risk exposure has implications for solvency regulation. On average, the risk weighted assets (RWA) of Spanish banks are apparently higher than those of other European counterparts. This represents a competitive disadvantage for Spanish banks.

Nevertheless, some of the other differences offered comparative advantages for the Spanish banking sector. In particular, Spanish banks have already faced a great deal of restructuring which is still needed in most European banking sectors. Likewise, Spain shows a lower cross-border sovereign risk exposure and a higher operating efficiency (see, for example, the recent Funcas publication: http://www.funcas.es/publicaciones/Sumario.aspx?IdRef=9-08011).

Reform focus from 2009-2011: Restructuring and recapitalization

The first important milestone in the bank restructuring process in Spain took place in June 2009, with the approval of the Royal Decree-Law 9/2009, which created the so-called Fund for the Orderly Restructuring of the Banking Sector (FROB). The FROB is one of the main pillars of the banking reform in Spain. The RD-l 9/2009 included a set of measures to address some of the weaknesses shown by Spanish banks at that time. The text of the decree provided the following rationale for reform implementation: "the situation of the Spanish banking sector cannot be described as normal, although given their size, those individual institutions likely to encounter difficulties are not systemic." Nonetheless, "if we consider their viability problems overall, a potential systemic risk could be created. The potential risk justifies the provision of early instruments and public resources in the event that circumstances make their use necessary... and the sector would find hard to sustain such losses through reliance on the three Deposit Guarantee schemes."

As for the functioning of the RD-l 9/2009, three different scenarios were considered:

(i) The search for a private solution by the troubled bank itself (basically taking the form of mergers with one or more institutions);

(ii) Actions to tackle weaknesses that may affect the viability of the bank and that could be covered with the existing Deposit Guarantee Fund;

(iii) An orderly restructuring process with the involvement of the FROB. The FROB could also participate as part of a financial viability plan in the event of a merger.

In practical terms, the RD-l 9/2009 forced all Spanish banks to present viability plans to identify if they were in need of any of the solutions considered. The Bank of Spain itself released a note saying that the FROB was a "painstaking process because of the variety and significance of the regulatory adjustments required and because of the complex decisions and negotiations entailed." (http://www.bde.es/webbde/en/secciones/prensa/reestructura_sane/ficheros/Notareformacajas20110217_IVI_en.pdf). The note also mentioned that "the restructuring of the savings banks sector was unavoidable... since the sector had several structural limitations associated with its legal nature, such as the legal restrictions on raising high quality capital other than via retained earnings and a complex and rigid system of governance not conducive to best corporate governance practices." Reform emphasis from that moment onwards was placed on savings banks. However, as it has been shown by the most recent developments in the Spanish banking sector, the solvency problems were not exclusive to the savings banks. In fact, most Spanish banks are currently affected by restructuring processes on some level.

In any event, the implicit focus made on savings banks by the RD-l 2/2009 was reinforced by a new law in 2010 that was explicitly oriented to savings banks, the Royal Decree-Law 11/2010 of July 9th, 2010. Prior to the RD-l 11/2010, savings banks relied mostly on retained profits to increase their solvency ratios. Given that one of the main regulatory responses to the crisis has been requiring more bank capital (i.e. Basel III requirements) the limitations of savings banks to access market financing had to be removed. The Royal Decree-Law 11/2010 addressed these limitations in two main ways:

first, it increased the flexibility of rules governing existing core capital instruments, cuotas participativas (capital certificates) to allow for these instruments to carry voting rights. However, reliance on this type of financing since 2010 has been very limited. Second, and most important, it allowed for alternative ways for a savings bank to transfer all its banking activities to a bank (a public limited company) and remain as a holding institution or even an ordinary foundation, dedicated to the promotion of social works. This was a critical step during the Spanish bank restructuring process, as far as savings banks were concerned, for two main reasons:

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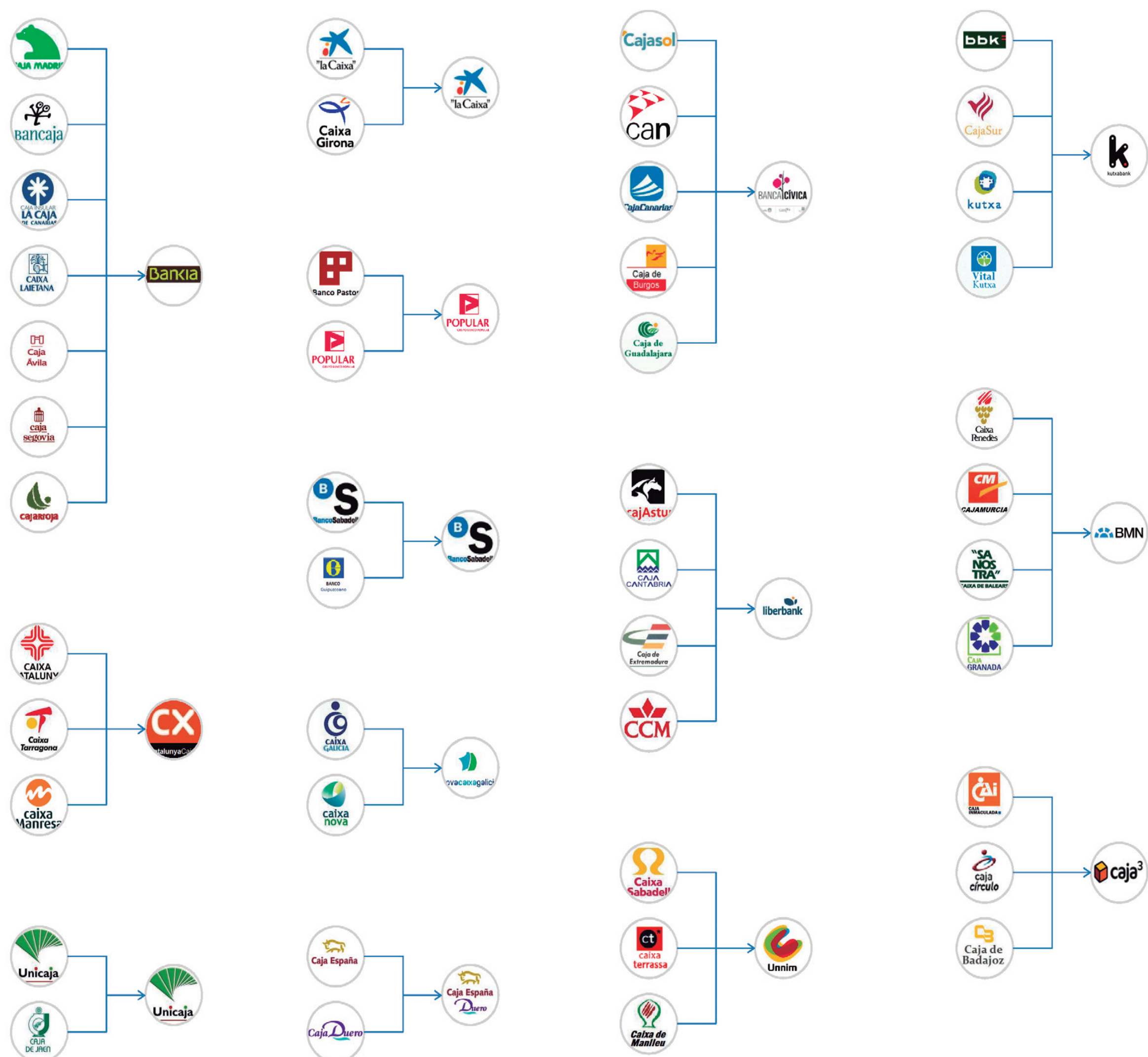
- Savings banks were able to maintain their foundational nature and, therefore, the institutional diversity of the Spanish banking

Exhibit 2. The bank restructuring process in Spain: merger processes (2009-2011)



Source: authors' elaboration.

sector was legally guaranteed.

- The RD-l 11/2010 enhanced the development of larger savings bank groups, with a core financial centre that took the form of a commercial bank. This permitted the new banking groups to have better access to capital markets and liquidity, while the regional scope and relationship banking nature of the savings banks' model was maintained within the banking group.

The third regulatory event that comprised the Spanish bank reforms was the Royal Decree-Law 2/2011 on the strengthening of the Spanish financial system. The aim of the recapitalisation of the banking sector was that all Spanish banks should have a core capital ratio of at least 8% (10% if they were not a listed company and, hence, had difficulty accessing to equity markets, as experienced by some of the savings banks). Those that did not meet the new minimum requirements had until September 30th, 2011, to increase their capital, either through reliance on private investors or through the FROB.

The results of the restructuring and recapitalization process from 2009 to 2011 can be summarized as follows:

- Following the RD-l9/2009, the number of savings banks was reduced from 45 to 17 resulting from 13 merger processes (see Exhibit 2).

- 8 out of the 13 integration processes received FROB support for a total amount of €10.58bn.

- Three institutions were seized, including Caja Castilla La Mancha, Cajasur and Caja de Ahorros del Mediterráneo.

- The process of recapitalization required by the RD-l2/2011 was completed with the contribution of €7.5bn from the FROB and €5.9bn from private sources of capital. According to the Bank of Spain, overall, the total amount of recapitalization was €13.4bn: http://www.bde.es/webbde/en/secciones/prensa/Notas_Informativ/anoactual/presbe2011_37e.pdf

- Three institutions were recapitalised and partially nationalised by the FROB (Novacaixa Galicia, Catalunya Caixa and Unnim).

- Additionally, Banco Sabadell acquired Banco Guipuzcoano and has also acquired Caja de Ahorros del Mediterráneo in a public auction process. Banco Popular and Banco Pastor have also merged.

- There is also another merger operation in progress between Unicaja and Caja España Duero.

The reform agenda's current priority: Balance sheet clean-up to restore confidence

Even if the banking sector experienced a significant restructuring and consolidation following the regulatory initiatives undertaken from 2009 to 2011, the main outstanding challenge for Spanish banks remained the asset impairment problem linked to their real estate market exposure.

Towards the end of 2011, the debate on the likely impact of a potential clean-up of assets in the Spanish banking sector was very intense. Last October, the three deposit-guarantee funds (for commercial, savings and cooperative banks) were merged into one entity so that commercial and savings banks could eventually share losses that may arise when any credit institution is seized. An important fact occurred in early December when the government increased the contributions that banks make to the deposit-guarantee fund and allowed the fund to take on debt. A new maximum contribution of three euros per 1,000 euros of banks' deposits was established, up from two euros, The reform was designed to allow the deposit-guarantee fund to "fully fulfil its functions".

Last February 3rd, the government approved the Royal Decree-Law 2/2012. The rationale states that the measures were "designed to clean up institutions' problematic exposures to construction and real estate developers in Spain - particularly land – from their balance sheets… as well as to consider potential migrations of assets from normal to problematic portfolios."

Most of the reform was directed at introducing new provisions and fostering further sector consolidation. Through this approach, the government was giving priority to private sector based solutions before imposing additional costs on taxpayers. The new provisioning scheme seems simple but there are several exceptions and specific features with very relevant implications.

Importantly, the new provisions are applied to the stock of legacy assets as of 31.12.2011 and not to new loans or assets. The reference framework to estimate the impact of the new provisions are the accounting statements of banks as of June 2011. The total exposure to risk (construction and development) of Spanish banks was estimated at €323bbillion (€175bn are considered to be non-performing or substandard).

There are three types of new provisions considered:

- Specific provisions to address incurred losses in problematic assets, particularly in land - estimated at €25bn.
- Capital add-ons to protect against valuation uncertainties regarding land and housing under development - estimated at €15bn.
- General provisions to take into account the potential migration from normal to problematic portfolios - estimated at €10bn.

Hence, total new provisions are estimated at €50bn. It is important to note that Spanish banks had already charged €66bn in provisions to profit and loss accounts, €22bn to reserves on banks undergoing restructuring, and €17bn corresponding to dynamic/statistical provisions.

The bulk of the new provisions will be for land and housing under development. Only considering specific provisions, the coverage ratio of land is projected to increase from 31% to 60% and that of housing under development from 27% to 46%.

There are also other specific provisioning requirements. In particular, in the case of repossessed finished housing and other real estate developer collateral, the value of the provisioning coefficients has been increased in relation to the time that the asset has been held on the bank's balance sheet: 10% (1st year); 20% (2nd year) and 30% (3rd year) to 25% (1st year); 30% (2nd year); 40% (3rd year) and 50% (4th year).

Similarly, provisions for doubtful loans on finished housing have been set at 25% and for substandard loans at 20%. In the case of foreclosed housing from households, the provisioning coefficients are now set at: 10% (1st year); 20% (2nd year); 30% (3rd year) and 40% (4th year). For other loans with personal guarantees classified as substandard, the minimum provisioning coefficient increases from 10% to 24%.

As for the new general provisions, the idea is to prevent a macroeconomic deterioration from turning currently performing loans into non-performing ones. Importantly, this is only for outstanding loans as of December 2011 and it is not applicable to new loans. It is also worth noting that this is not a reform of the current Spanish dynamic provisioning scheme but a one-off measure (and does not enter into the definition of regulatory capital).

The third element, the new capital add-on of €15bn, is for land and housing under development classified as part of the problematic portfolio. This capital add-on is established on top of the minimum solvency requirements.

With these three elements of the new provisioning scheme, the Spanish authorities claim that the coverage ratio on housing under development will increase to 65% and the coverage ratio on land will increase to 80%.

The new banking reform gives preferential treatment to institutions that present merger plans. Under normal circumstances (i.e. in the absence of anticipated mergers) the timeline for meeting the provisioning requirements will be as follows:

- March 31st, 2012: presentation of a plan to comply with the measures
- BdE approval within 15 working days
- Year-end 2012: compliance with the measures

In order to facilitate these processes, the FROB can buy shares of the institutions. These shares must be sold through a competitive procedure within a maximum period of 3 years.

In the case of anticipated merger, the timeline will be as follows:

- May 31st, 2012: presentation of an integration plan
- Approval by the Ministry of Economy within one month
- 12 months after the approval of the integration plan: compliance with the measures. The integration must be operative by January 1st, 2013, at the latest.

Importantly, the FROB can also provide funds to facilitate the processes through CoCos (convertible into shares within 5 years).

Assessing the reforms' impact in a difficult context

The RD-I 2/2012 has set a path for the clean-up of Spanish banks' balance sheets. As these rules are being currently implemented, it is difficult to make an assessment of their effects but there are some relevant issues that are currently under debate, including some remaining challenges.

Overall, one of the most positive features of the banking reform is that the €50 bn in provisions should help clean-up balance sheets to a significant extent. As of now, most of the necessary €50bn will have to come from the banking sector itself. However, the FROB can still leverage up to €90bn. Importantly, FROB funding does not constitute an increase in the "public deficit" because the funds are borrowed by the credit institutions and therefore are considered temporary bail-out funds.

If economic activity in Spain does not improve, the level of required bank provisions could increase again. This new roadmap has the advantage that it can be changed over time so that, for example, a new general provision could be approved if necessary. In any event, the clean-up of assets should ideally be combined with outside investors' participation in troubled banks that would help to improve their financial structure and reduce the potential impact of the clean-up of banks' balance sheet on public finances.

Interestingly, those banks involved in new mergers will be granted an additional year to comply with the new provisioning rules - receiving 2 years instead of 1. The merger must also lead to "improvements in corporate governance and the adherence to established objectives on lending to households and SMEs" by the resulting institution. However, it will be difficult for banks to generate new be difficult for banks to generate new loans and make significant profits with so many binding regulatory pressures in a context of a foreseeable deterioration of macroeconomic conditions. As for the new dynamic provisions, currently performing assets which become non-performing in the future will still be subject to previous regulations. According to the Bank of Spain "when a loan classified as normal is re-classified to the problematic portfolio, the amount accumulated in this fund of provisions can be used to the extent necessary depending on the provisioning requirements implied in the re-classification. These potential re-classifications will not have an impact on the P&L until the provision fund constituted as a result of the application of the new measures is completely depleted."

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Another relevant question is the extent to which the reform can contribute to further downward adjustment to Spanish housing market prices. Home prices have only decrease around 17% from 2008 to 2011. Most analysts estimate that these provisions will help to drive prices further downward by 15-20% over 2012 and 2013, so that the total fall from peak will be around 35% on average. It is also important to bear in mind that the new provisions and the expected fall in home prices will have a negative (but necessary) effect on household wealth.

As for savings banks, the evolution of the banking sector has revealed that the exposure to real estate assets is a common weakness of the Spanish banking sector and is not specific to savings banks. Progressively, more commercial banks are getting involved in integration processes and they are making substantial restructuring and efficiency efforts to adjust to the new environment. In any event, it would be beneficial to preserve the institutional diversity of the Spanish banking sector to some extent, given that this diversity has contributed to bank competition and the promotion of relationship banking at the regional and local level over the last forty years.