Cleaning up Spanish Bank Balances: Restoring confidence, but is this enough?

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Recent legislation is a step forward in the right direction, but it may not be sufficient to cover the future provisioning needs arising from further potential loan deterioration

Significant progress has been made on regulatory reform of the Spanish banking sector in particular with regards to consolidation, and improved corporate governance, and most recently, strengthening provisioning requirements on real estate related assets. Overall, the new provisioning requirements for impaired assets related to real estate exposure should be sufficient to account for the anticipated further decline of real estate prices. However, in our view, questions remain regarding the ability of banks' balance sheets to withstand potential additional reclassifications of currently normally performing real estate assets as impaired assets – a scenario which could realistically materialize over the coming years. Moreover, we must also consider whether or not more coverage is needed on other types of bank portfolio assets, such as corporate and mortgage loans, whose quality could also be subject to deterioration in the face of the negative economic outlook.

New Legislation: a step in the right direction

One month after taking office, the incoming Spanish Government approved a new piece of legislation aimed at restoring the confidence in the banking system. The Royal Decree published on February 2nd rested on a three pillar solution: a) a comprehensive set of requirements for additional write offs in bank assets related to real estate ; b) new incentives to additional rounds of consolidation among banks; and c) new rules for improving corporate governance in the banking sector. The new banking measures form part of a wider package of economic reforms also covering a set of measures addressed at restoring fiscal discipline, especially in the decentralized regions and municipalities; as well as an aggressive labor market reform.

Overall, the new measures are a step in the right direction, as they try to restore confidence by increasing the write-downs on the impaired assets on the balance sheets of banks. We believe that the further write-downs required by the new Decree-Law are enough to meet the needs arising from current impaired assets related to real estate and construction. However, they may not be sufficient to cover the future provisioning needs arising from other loans, such as SME´s, or even mortgages, whose nonperforming rate has been well contained so far but may start rising.

Previous measures taken to restore confidence

Since the beginning of the crisis Spanish banks have been considered to be among the most vulnerable to asset impairment: their exposure to

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real estate related assets was higher than in any other country except for Ireland; and the Spanish economy was also one of the most affected by the crisis.

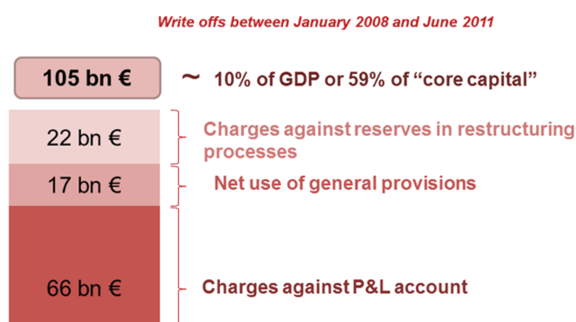
Contrary to other countries, whose toxic asset exposure was mainly in the form of securities (ABS, MBS, derivatives, etc.) exposure of Spanish banks to real estate is mainly in the form of loans, especially to real estate developers. This is the main reason for the delay in applying measures to clean up balances in Spain. Most countries applied intense state aid programs already in the early months of 2009 to strengthen banks' balances. Bad banks or asset management agencies were put in place in many countries as a way of cleaning up bank balances. Those institutional arrangements usually took the form of asset transfers to a bad bank structure, or providing asset protection schemes to clean-up toxic assets from banks' balance sheets.

None of those arrangements was taken in Spain during 2009. In fact, it was not until mid 2010, with a one and a half year delay versus most countries, that Spain recognized that its banking system was also in need of a restructuring and cleaning up of its balances in order to restore confidence and help normalize the flow of funds to the economy.

The delay in taking action has not prevented the Spanish banking system from being subject to intense regulatory activity during the last two years:

- Almost 20 integration processes have been undertaken (12 involving savings banks, 2 involving private banks, and the rest in the smaller credit cooperatives) reducing the total number of financial entities to just over 60. Those integration processes allowed write downs against reserves for a total €22bn (2.2% of GDP).
- Besides those charges against reserves, €66bn have been charged against profits; and €18bn against general dynamic provisions. Total write offs, therefore, amount to over 10% of GDP, as can be seen in Exhibit 1 below.
- Capital injections from the public sector, by an overall amount close to €20bn (2% of GDP), 60% in the form of preference shares and the rest in direct equity stakes.
- Approval of different Decree-Laws that produced a complete overhaul of the special status of savings banks; in fact, forcing all of them to transform into private banks
- Public quotation in the stock exchange of three of those banks resulting from the savings banks transformation;
- Legal intervention of four entities, and virtual nationalization (public sector holding majority stake) of three additional ones; together, all of the seven entities taken over amounted to about 10% of total assets of the Spanish banking system.

Exhibit 1: Write offs between January 2008 and June 2011



Source: Afi, BdE

Yet, despite such intense activity around the banking system, there is a general belief that the goal has not been met in terms of restoring confidence as long as:

- The system is under suspicion of not having cleaned-up sufficiently bad assets, especially those related to real estate. That suspicion, together with current difficult financial markets conditions, has been preventing banks from accessing financial markets to issue virtually any type of securities.
- Nonperforming and repossessed assets have been growing steadily, up to levels clearly higher than those anticipated when the integration plans were put in place.
- The flow of new credit to the economy is severely impaired: total outstanding bank

credit fell in 2011 by 5%; but, what is worse, new credit granted fell by over 30% during that year. This is particularly severe for a country like Spain, with a heavy bias towards bank finance, and with virtually no other sources of finance for small and medium size enterprises.

It is for all of those reasons that a new impulse was needed in terms of reforming the banking system. That was the main objective of the new measures contained in the Decree-Law published on February 2nd, with three main aspects of reform: a) a comprehensive set of requirements for additional write downs on bank assets related to real estate, b) new incentives to additional rounds of consolidation among banks; and c) new rules for improving corporate governance in the banking sector.

Additional write-downs: will they be enough?

As mentioned previously, a total €105bn has already been written off banks' balance sheets, a figure larger in relative terms (10.5% of GDP) than in most countries in which banks have been hit by asset deterioration. And yet, it is generally assumed, especially for assets related to real estate and construction, that additional haircuts are needed in order to improve credibility of the

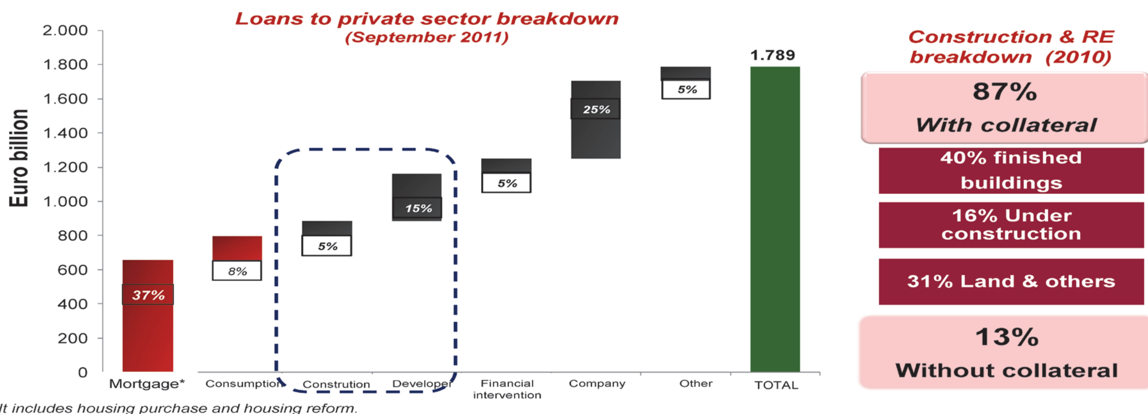
As can be seen in Exhibit 2, total outstanding credit to the private sector in the Spanish banking system amounted, at mid 2011, to €1.8bn, out of which almost 20% is related to real estate developers and construction activities, by far the sector most heavily damaged by the crisis. Out of that total exposure to real estate, almost 50% either had no collateral at all, or were collateralized by land, whose value as a guarantee has probably deteriorated significantly.

The more vulnerable nature of real estate loans is evident if we analyze the breakdown of

nonperforming assets in the overall credit portfolio of the Spanish banking system, as can be seen in Exhibit 3. With a weight of less than 20% of the total loan portfolio, real estate and construction account for almost 60% of total nonperforming assets.

In fact, impaired assets in that sector are much

Exhibit 2: Loans to private sector breakdown, September 2011



Source: Afi, Bank of Spain and information submitted by credit institutions

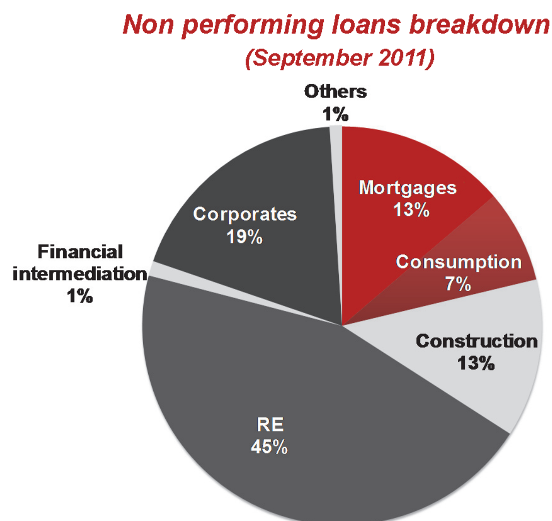
banks' balance sheets.

Without resting importance to aspects b) and c), we will center on the asset write down measures.

These are not formally nonperforming, but there are serious doubts on the debtor's capacity to face maturities. A large amount of loans in this category have been refinanced to longer maturities, and with higher financing costs, but in many cases with no improvement at all in the underlying guarantees.

higher than the corresponding figures from nonperforming loans. They must include also repossessed assets as well as those loans classified by the supervisor as substandard.

Exhibit 3: Non performing loans breakdown, September 2011



Source: Afi, Bank of Spain and information submitted by credit institutions

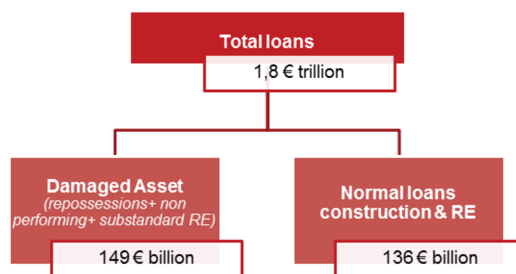
Exhibit 4 summarizes the overall picture of total construction and real estate exposure: a total amount close to €290bn, over a total €1.8bn loan portfolio. Of that exposure, about €140bn are classified as normal, while €150bn are classified as impaired, in any of the three categories mentioned.

As stated previously, a special feature of the Spanish exposure to real estate is that it takes the form of loans, instead of securities. Those loans have been financing real assets like land, unfinished houses, and finished but unsold ones. All these types of assets, but especially the first and second, are extremely difficult to value on a market basis, as there is no active market for them.

This brings us to a debate about appropriate valuation methods for assets when there is no market for them. At one extreme of the debate is the so called "firesale" valuation, based on a forced sale of all those assets in a short period of time. At the other would be to apply historical prices, adjusted by the accumulated depreciation allowances. In the middle, long term valuation models can be applied based on a smoother supply to the market during a long period of time.

In relation to that range of possibilities, none of the major countries that have faced asset impairment within their banks have opted for valuations based on any of the two extremes, either "fire sale", or book value. On the contrary, most of them have assumed valuation models based on long term maturity periods.

Exhibit 4: Spanish banking system: Construction & Real Estate exposure in the overall loan portfolio, September 2011



It is in this context where the new writedown requirements imposed by the Spanish Government must be placed. Specifically, the Ministry of Economy defined an overall new figure of €50bn as the need for additional write downs on the different loans and repossessed assets related to real estate and construction.

The new figure, added to the efforts carried out so far (Exhibit 1 above) will bring total coverage of banks' balance sheets to an overall €155bn, that is over 15% of Gross Domestic Product, and 8% of total outstanding loans. The new figure, therefore, assumes an important closeness to "market prices" (at least under the long term valuation approach), while at the same time forcing the banking system to make an intense effort, in terms of charges against profits and reserves.

The required coverage varies, however, significantly between different categories of assets, depending on the degree of impairment, as perceived by the banking supervisor, as well as on the degree of closeness to completion of the overall value chain of the development-construction-sale process. On the other hand, the additional coverage is to be attained though a

Exhibit 5: Provision levels required

A. Detailed set of requirements

<table>
<tr><th rowspan="3">% Specific provision additional</th><th colspan="3">76%</th><th colspan="3">12%</th><th colspan="2">12%</th></tr>
<tr><th colspan="3">LAND</th><th colspan="3">HOUSING UNDER DEVELOPMENT</th><th>FINISHED BUILDINGS</th><th>PRINCIPAL HOMES. HOUSEHOLDS</th></tr>
<tr><th>Provisions</th><th>Capital Add-On</th><th>Total</th><th>Provisions</th><th>Capital Add-On</th><th>Total</th><th>Provisions</th><th>Provisions</th></tr>
<tr><td>REPOSSESSIONS</td><td rowspan="3">60%</td><td rowspan="3">20%</td><td rowspan="3">80%</td><td rowspan="2">50%</td><td rowspan="2">15%</td><td rowspan="2">65%</td><td>< 12 M; 25%
+12 M; 30%
+24 M; 40%
+36 M; 50%</td><td>< 12 M; 10%
+12 M; 20%
+24 M; 30%
+36 M; 40%</td></tr>
<tr><td>NON PERFORMING</td><td>25%</td><td rowspan="2"></td></tr>
<tr><td>SUBESTANDARD</td><td>50%
(in process, 24%)</td><td>15%
(in process, 0%)</td><td>65%
(in process, 24%)</td><td>20%
(24% personal guarantee)</td></tr>
<tr><td>NORMAL</td><td colspan="7">7%</td><td></td></tr>
</table>

Source: Afi, and press release Ministry of Economy and Competitiveness

B. Synthesis by type of assets

Asset type	Specific provision	Capital add-on	Generic provision
Impaired assets:			
Land	60%	20%	-
Under development	50%	15%	-
Finished houses	35%	-	-
Performing assets:	-	-	7
Total euros (bn):	25	15	10

combination of regulatory requirements.

Exhibit 5 shows the detailed disaggregation of the requirements, based on a multiple entry format:

a) by the nature of assets to be cleaned-up (land, construction in progress, or finished houses);

b) by the degree of damage of the assets (repossessed assets versus loans in doubtful, subprime, or normal situation);

c) by the regulatory instrument (specific provisions, general provisions, or additional capital requirements).

The biggest effort, with a €25bn requirement, takes the form of direct specific provision, to be registered in the 2012 profit and loss account, and is addressed to clean up impaired assets, with a much heavier burden on land (60% haircut), than on finished houses (35% haircut), with assets under development somewhere in the middle.

This type of distinction is logical, as long as land is an asset with much lower possibility of sale than houses, and it is subject to much larger price variations than houses, both in booms and bursts. As an example, during the boom years of 2000 to 2007, land prices increased twice as much as house prices.

Since the beginning of the crisis, almost five years ago, house prices in Spain have registered an average fall of 26% according to the most widely followed indices published by real estate appraisal firms. At the same time, urban land has registered a fall of 40%, while there are no statistics for nonurban land, with an absolute absence of transactions, and a likely fall which might double the one observed in urban land.

With such price behavior up until now, we might consider that the provisioning requirements go even further than the observed prices so far. For finished houses an additional 10% fall in prices is assumed, which may seem reasonable. As a matter of fact, a 35% haircut in bank loans to finished houses implicitly assumes a much larger fall in house prices, as long as the initial equity share of the developer (100 minus the Loan to Value ratio at the origin) acts as a first loss.

As for land, the haircut imposed by the direct specific provision is approximately equivalent to current market prices (assuming a 50/50 distribution between urban and nonurban land). The fact that land is a much more illiquid asset, and its price a much more volatile one, justifies the imposition of some additional contingent haircuts. This is the role to be played by the required capital add-on, by an amount of 20% of the overall land exposures under an impaired situation. This figure is not formally a charge, but a cushion set apart, which might help absorb additional losses in the event of further falls in land prices.

Finally, assets under development are treated somewhere in the middle; in fact closer to land than to finished houses, with a provisioning requirement of 50%, and capital add-on of 15%. This treatment seems reasonable and therefore appears to reflect the current market situation, and provides a cushion for contingent negative evolution in the future.

Overall, therefore, we might conclude that the new requirements imposed on impaired assets, €25bn of specific provisions and €15bn of capital add-on, may be sufficient to cover actual and potential losses on those types of assets.

We cannot share that view with regard to real estate assets whose current performance is classified as normal. As previously mentioned, there are almost €140bn of loans to real estate and construction classified as normal, and a general provision of €10bn (7% of gross value) is to be set against the profit and loss account.

Our doubts arise from the difficult situation, in terms of sales, that the overall real estate sector is suffering. And also, from the intense trend that we have witnessed in the last two years in terms of reclassifications of loans from normal to impaired status. If that trend continues in the next year, and our own

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forecasting models indicate this could be the case, at least one third of real estate loans that are currently performing might move to one of the three (repossessed, doubtful, or substandard) categories of impaired assets, and therefore be subject to much heavier haircut requirements than the ones being set now for the normal ones. Put in simpler terms, in our opinion, there is a much finer line that currently separates normal form impaired loans than reflected by the difference of treatment for both categories of loans under the new Decree-Law.

Additionally, we must also recall that the new provisioning requirements are related exclusively to real estate and construction, leaving aside the remaining loan portfolio. Two categories are especially worth mentioning in terms of potential asset deterioration not covered by the new requirements: loans to companies outside the real estate sector, and mortgages to households. In both types of loans, performance is going to be negatively affected by the economic environment during the next year, and no provisioning requirements are imposed upon them.