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Letter from the Editors

Over the past decade, the economic boom, the entry of Spain into the euro, and the crisis itself, have catalyzed a process of intense transformation of the Spanish financial system. Nevertheless, as a consequence of too much activity in the property sector (including real estate, construction, and household mortgages), banks have amassed a concentration of exposure in this area. The result has been a highly efficient Spanish banking sector, but also increased vulnerability in the current context of the crisis.

In this issue, we examine how the onset of the financial crisis, the bursting of the housing bubble and the resulting economic downturn put into evidence the accumulation of Spanish banks' overexposure to the housing sector. At a time when market concerns over sovereign risk are adversely affecting the ability of even the strongest financial institutions to gain access to funding, it is important to accelerate the process of correcting imbalances.

We provide a snapshot of the current state of banks' balance sheets, as well as recent government actions taken with a view to address the problems highlighted above. Such actions include the new measures approved on May 11th to introduce independent auditing on banks' property assets, isolate them from other performing assets, and introduce additional capital requirements for performing real estate assets on their balance sheets. We believe all of these measures will help to correct imbalances and more importantly, help to distinguish the good from the bad.

In our view, the latest measures will accelerate consolidation of the financial sector. Moreover, the independent valuation will help assign a credible value to property assets, allowing investors to differentiate on the basis of asset quality. As a next step, investors will be able to apply this differentiation on a greater scale – separating solid financial institutions and corporations from weaker ones. They will also be able to tap into potential opportunities for productive investment within the Spanish economy. Nevertheless, going forward, it will be critical to define how the so-called backstop mechanism will provide the necessary resources and guarantees on potential losses, in the event that the magnitude of the impairment is higher than expected.

In addition to the situation of Spain's private sector debt, we provide some insights on the state of regional debt markets. We explore ways to improve the regions' financing mechanisms, including preliminary thoughts presented by our contributing authors on the on-going hispabonos debate. This debate brings with it a series of potential positive, as well as negative considerations, in the event that it finally implies a State guarantee over regional debt. Additionally, we include an update on recent trends in the evolution of holders of Spanish government debt.

Another important issue we analyze is the 2012 budget, along with its implications for the regional governments. Finally, we also summarize the relevant regulatory actions the government has taken over the past few months.

We believe that proactivity is on the rise with respect to addressing critical challenges. As you read through the key themes of this issue of our publication, we trust that you will come away with the same impression.