The specialisation of the Spanish banking sector: Building on original strengths, while adapting to a more challenging environment

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The Spanish banking sector has evolved rapidly over the past decade. In order to survive in the current environment, this evolution must continue, taking into account key elements such as efficiency, diversification of activities, and internationalization.

The Spanish economy and in particular the banking sector have undergone an intense period of transformation driven by European integration, economic boom, and the financial crisis itself. This article analyses one of the key aspects of this transformation process - the specialisation of the Spanish banking system - over the past decade and within a European context. We conclude that, while originally an important strength of the Spanish banking model, the specialisation of the originate-to-hold, retail banking business into the property market, together with overexpansion of installed capacity, are some of the imbalances that need to be corrected to ensure the health of the sector. This is particularly important at a time when access to wholesale finance remains restricted and a period of significant economic slowdown and deleveraging lies ahead. Going forward, in parallel to the on-going restructuring efforts, the banking sector must also expand services, reorient business towards more productive sectors, increase its share of non-interest income, and importantly, internationalize.

Since joining the European Monetary Union in 1999, the Spanish economy has undergone an extensive process of transformation and development. These changes have also affected the banking sector, which has experienced profound transformations in terms of aspects such as: i) productive specialisation, ii) the composition of the industry, iii) internationalisation and openness to the rest of the world; and, iv) an intensification of competition. Prior to the outbreak of the current crisis in mid-2007, the economic boom, in conjunction with the process of European financial integration, accounted for much of the transformation taking place in the Spanish banking sector. Similarly, the ongoing crisis itself, representing a shock of sufficient magnitude, together with the measures taken to mitigate its impact, can explain the structural changes occurring in the sector.

Against this backdrop, this article focuses on one aspect of this transformation, looking in

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particular at the specialisation of Spanish banks in the European context and the changes that have taken place over the past decade. The period examined includes the years from 2000 to 2011, covering Spain's adoption of the euro and its subsequent economic expansion, together with the impact of the crisis in 2008-2011. The analysis draws on information published by the European Central Bank (ECB) in the form of aggregate Monetary Financial Institutions' (MFIs) balance sheets, supplemented with more detailed information from the Bank of Spain.

As we shall see, the model of retail banking - typical of the Spanish banking sector -characterised by its proximity to the customer (and supported by an extensive network of branches) represented a strength at the start of the crisis. However, the intensity and duration of the crisis, and the high degree of concentration of risk in the property sector, brought to light the existence of imbalances that still have to be corrected. Thus, although the generate-to-hold business model meant Spanish banks were not exposed to toxic assets in other countries, the sector's rapid specialisation in real estate and the excessive rate of credit growth underlie the problems it faces today. Going forward, Spanish banks will have to make their specialisation in financial intermediation compatible with the necessary correction of their excess installed capacity, and an increase in the relative importance of non-interest income.

Spanish banking system specialisation in the European context

An analysis of the differences in financial institutions' balance-sheet composition (on both the assets and liabilities sides) is crucial to explaining the differences observed in terms of aspects such as margins, income structure, transformation costs, default rates, liquidity, etc. Each particular banking business orientation (investment banking, retail banking, corporate banking, universal banking, specialised banking, etc.) has its own characteristic income and expenditure structure. Consequently, the differences observed between institutions in terms of economic and financial ratios can only be understood when the differences in productive specialisation are taken into account.

The standard approach to analysing banking specialisation is based on the composition of the balance sheet, to the extent that the liabilities reflect the financial structure and sources of financing and the assets demonstrate how this financing was used.

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As shown in Exhibits 1 and 2, the main feature of Spanish banks in comparison with other European financial sectors is the high relative proportion of deposits and loans, implying a model typical of financial intermediation. Specifically, in late 2011, lending accounted for 61.9% of total assets, compared with an average of 55.1% for euro-area banks. Spain's banks are in second place in the euro area in terms of the significance of lending on their balance sheets, surpassed only by those of Greece (64.7%). In the case of deposits, Spanish banks are the most specialised with respect to this type of financing, as deposits represent 62.2% of the balance sheet, 11.2 percentage points above the euro-area average.

If we focus on the non-financial private sector, Spanish banks also lead the euro-area in terms of their degree of reliance on deposits as a source of financing, which represent 47.6% of total liabilities, 15 percentage points above the European average.

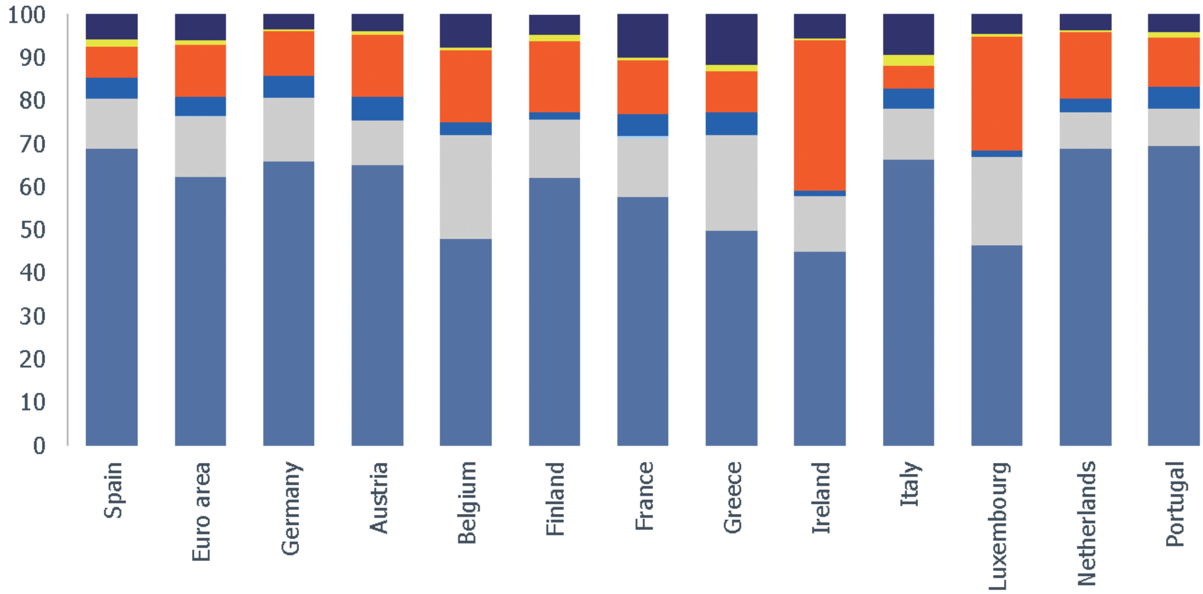
Moreover, in the case of lending, loans to

Exhibit 1

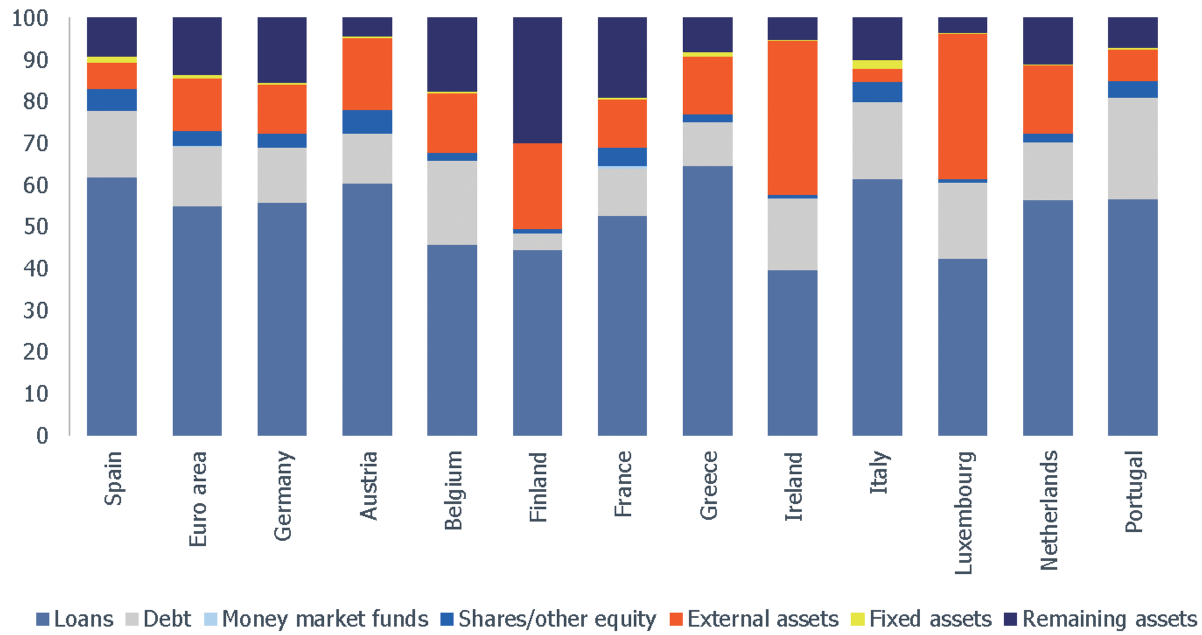
Percentage distribution of assets of Monetary Financial Institutions

(%)

a) 2000



b) 2011



Source: ECB and author's calculations.

businesses and households account for 50.4% of total assets in Spain, 17.2 percentage points more than in the euro area, second only to Greece, and far ahead of Germany (30.7%), France (25.3%) and Italy (42.8%). The relative weight of this item highlights the importance of private-sector financing in the range of activities conducted by Spanish banks.

Another notable feature of the Spanish banking sector is the greater importance of lending to the private sector, and by contrast, the lesser importance of lending to other MFIs. As is apparent in Exhibit 3, which shows the percentage distribution of lending to the private sector, loans to other MFIs represent 14.5% of total lending, which is less than half the comparative figure for other European banks (33.5%). The greater relative weight of credit to the non-financial sector concerns both loans to businesses (38.4% in Spain vs. 25.4% in the euro-area) and households (32.5% vs. 23.8%). This trait is explained by the larger share of lending accounted for by mortgages in Spain. Thus, home loans account for 29.4% of total private-sector lending, a proportion 9 percentage points higher than the euro-area average.

In the case of inter-bank lending, Spanish banks are less specialised than their counterparts elsewhere in Europe, with deposits and loans representing 15% and 9% of the balance sheet, respectively, compared with euro-area averages of 18.8% and 18.4%. The high net negative exposure of the Spanish banks in the inter-bank market is thus apparent, with a difference of 9 percentage points between share deposits and loans with other MFIs on their balance sheets.

In addition to Spanish banks' high degree of specialisation in the lending market, they also have a larger share of investments in fixed income securities, accounting for 16% of total assets, compared to 14.2% for euro-area banks. A closer analysis of the composition of fixed income portfolios reveals that this is explained by investments in securities issued by the non-financial private sector, as in Spain these investments account for 8.3% of total assets, compared to 4.6% in the euro area. The weight of public debt in Spanish banks' balance sheets also exceeds the European average (5.7% vs. 4.1%).

On the liabilities side, issuance of fixed-income securities has taken on greater importance in Spain, with a weight of 12% compared to 15% among euro-area banks. Nevertheless, as will be explored in more detail below, the increasing recourse to wholesale market finance, particularly through the issuance of covered bonds, is one of the main changes to have taken place in the Spanish banking sector's specialisation in recent years.

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The relative weight of investment in equities is also higher in Spain in comparison to the average for euro-area banks. Specifically, at the end of 2011, shareholdings represented 5.1% of total assets, compared to 3.6% in the euro area. Only Austria had a percentage higher than that in Spain, with investments in equities playing a relatively minor role in countries such as Luxembourg, Finland and Ireland. These equity investments in various different sectors have enabled institutions to bolster their income with dividend flows. On the liabilities side, Spanish banks' degree of capitalisation is also greater, capital and reserves representing 10.2% of the balance sheet, a figure 3.6 percentage points higher than the euro-area, and behind only Greece.

Finally, another point that stands out in the specialisation of Spanish banks in the European context today is the relatively low degree of investment and financing outside the euro area.

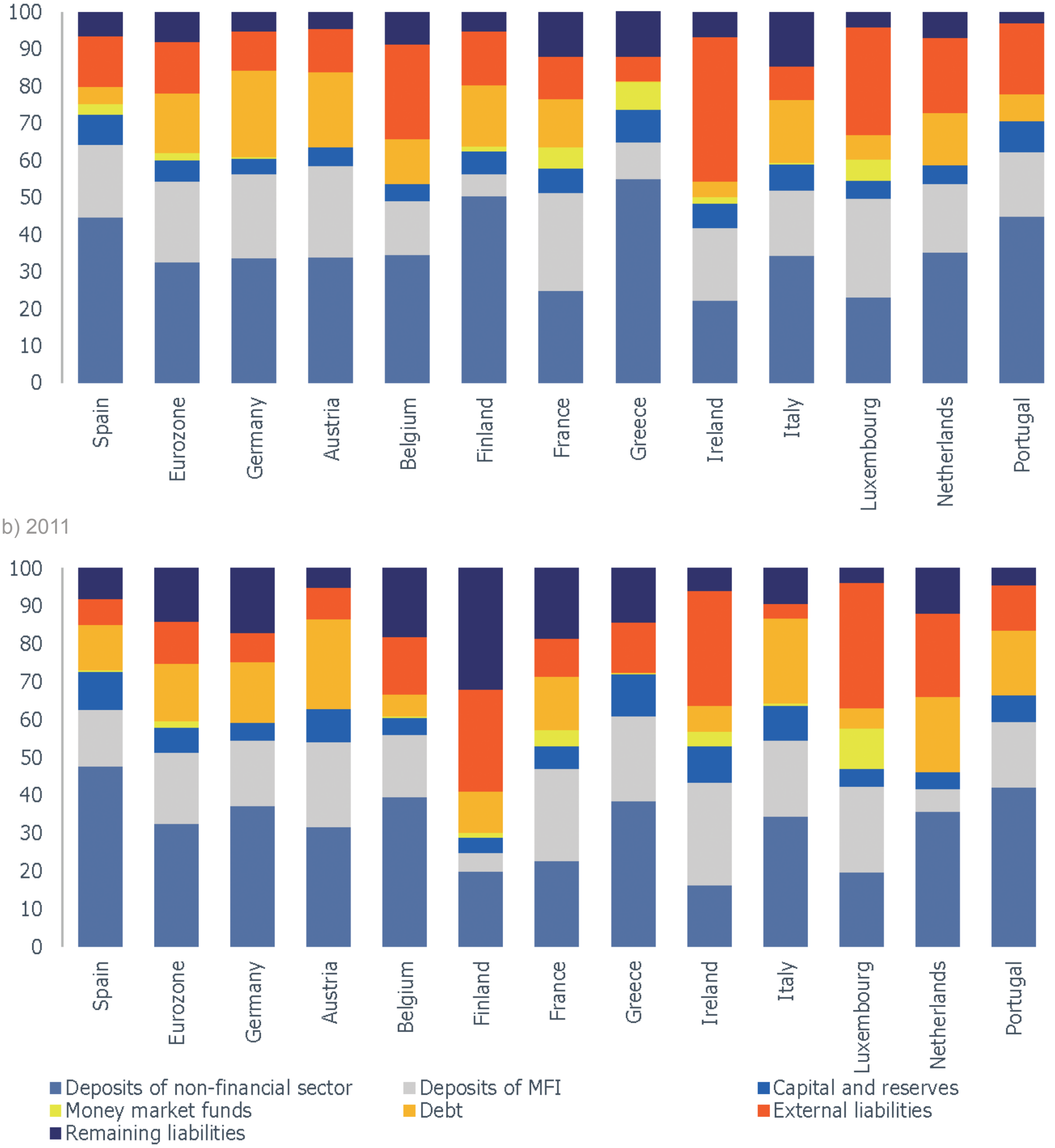
Exhibit 2

Percentage distribution of liabilities of Monetary Financial Institutions

(%)

a) 2000

b) 2011



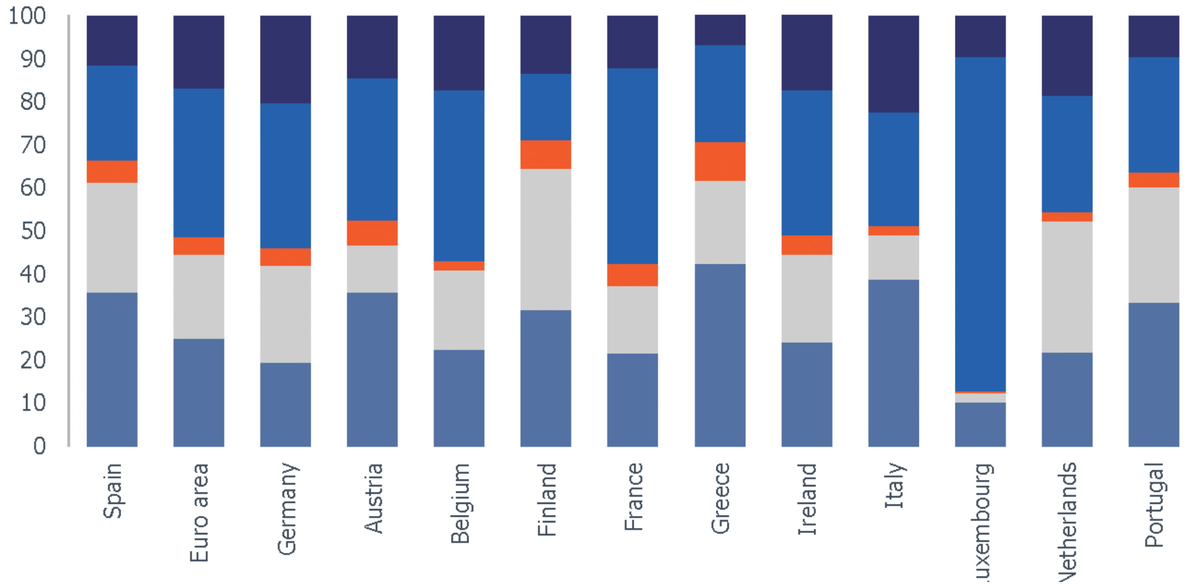
Source: ECB and author's calculations.

Exhibit 3

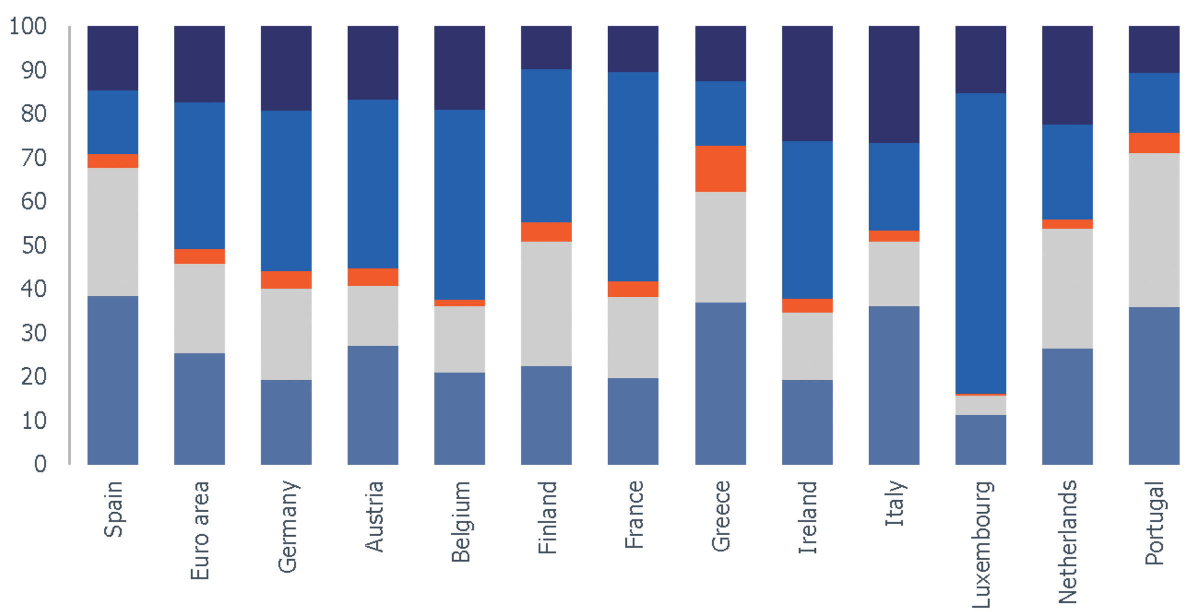
Percentage distribution of lending by Monetary Financial Institutions

(%)

a) 2003



b) 2011



Non-financial corporations   Lending for house purchase   Consumer credit   MFI   Other lending

Source: ECB and author's calculations.

This is indicative of the banks' more limited degree of internationalisation. In particular, external assets (from outside the euro area) represent only 6.2% of assets (compared to 12.6% in the euro area), while external liabilities represent 6.9% (11.7% in the euro area).

Changes in specialisation: 2000-2011

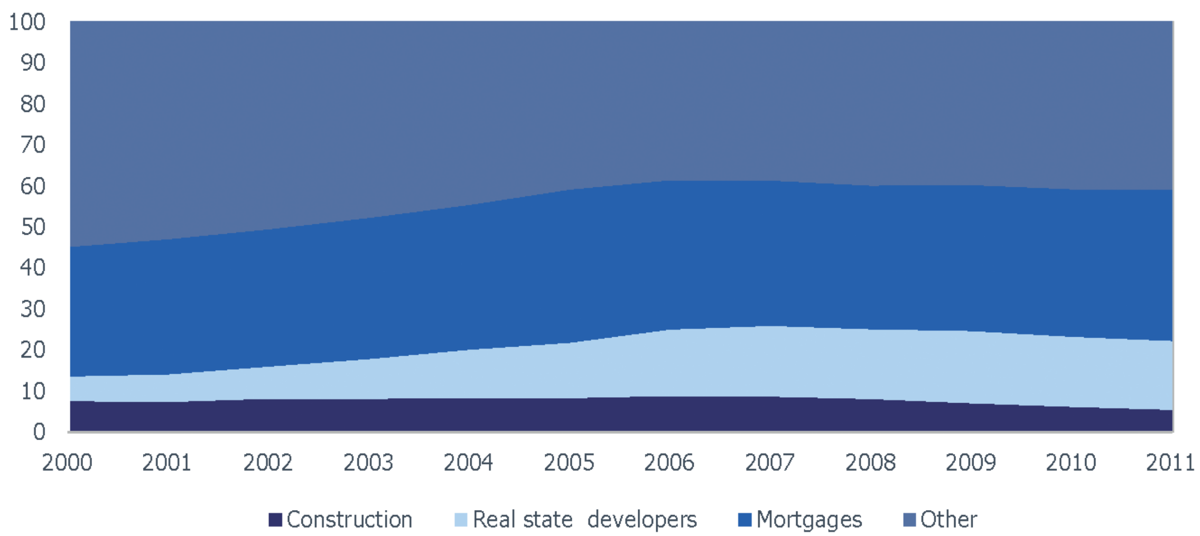
Comparing the 2011 balance sheet with that of 2000 reveals a number of noteworthy features of the changes in banking sector specialisation in the European context. On the asset side, the most striking feature is that while in Spain, the relative share of fixed income has increased by 4.4 percentage points, among euro-area banks, it has remained unchanged from initial levels. Another salient point is the drop in the percentage that loans represent on the balance sheet, with the drop being similar in Spain (7.2 percentage points) and the euro-area (7.3 percentage points). However, this aggregate decrease conceals important differences. These can only be analysed from 2003 onwards, as the ECB did not publish detailed information on the lending breakdown in previous years. Thus, comparing the current composition with that existing in 2003 (see Exhibit 4), the drop in Spanish banks' total assets attributable to lending is largely due to the declining significance of lending to MFIs and, to a lesser extent, consumer credit, while lending for home purchases and to businesses actually increased. Against this change in the lending mix, the composition in the euro area is much more stable, with a slight drop in lending to MFIs and consumer credit, and an increase in total lending for home purchases.

The biggest change in the composition of Spanish banking sector liabilities is the 7.5 percentage point increase in the share of fixed income securities issuance in total liabilities. This contrasts with the drop of one percentage point among euro area banks and is explained by Spanish banks' increasingly turning to the wholesale markets for finance. Also noteworthy is the increase in the importance of deposits from the non-financial sector as a source of financing and the drop in the

Exhibit 4

Percentage distribution of lending to the resident private sector by Spanish credit institutions

(%)



Source: Bank of Spain and author's calculations.

weight of deposits from other MFIs.

Lending specialisation: the focus on the property sector

As mentioned above, the composition of credit in Spain differs substantially from that in the rest of the euro area in that lending to the non-financial private sector is more significant and inter-bank lending is less so. In the case of the former, the information provided by the ECB reveals Spanish banks' greater orientation towards providing home loans.

Drawing on the more detailed information about credit institutions provided by the Bank of Spain, the feature that stands out most strongly is the increase by almost 14 percentage points in lending to the property sector (understood in the broad sense to include construction, real estate development, and home purchases), which came to represent 59.1% of private-sector lending in December 2011. Lending for real-estate development activities underwent the fastest growth, gaining 10.7 percentage points of the total, versus 5.2 percentage points in the case of mortgage lending.

The concentration of credit in activities related to the property sector reached a peak of 61.4% in late 2007, at precisely the moment the property bubble burst. Since then, the serious crisis being suffered by the Spanish property sector has translated into an acceleration of the banks' non-performing-loan rate, which reached 20.9% on lending to real-estate developers and 17.7% on construction lending. On the other hand, in the case of personal home loans, default rates remain at very low levels (2.8%).

In this context, the necessary process of deleveraging has been intense in the case of construction lending (the share of construction lending in the total fell by 3.4 percentage points between 2007 and 2011), whereas in real estate activities, it has only dropped by 0.5 percentage points (the outstanding stock has fallen by 8.1% since its peak in June 2009, compared with a drop of 37% in the case of construction since the maximum reached in September 2008), which highlights the significance of the refinancing activities taking place in the property sector.

Financing the private vs. public sector

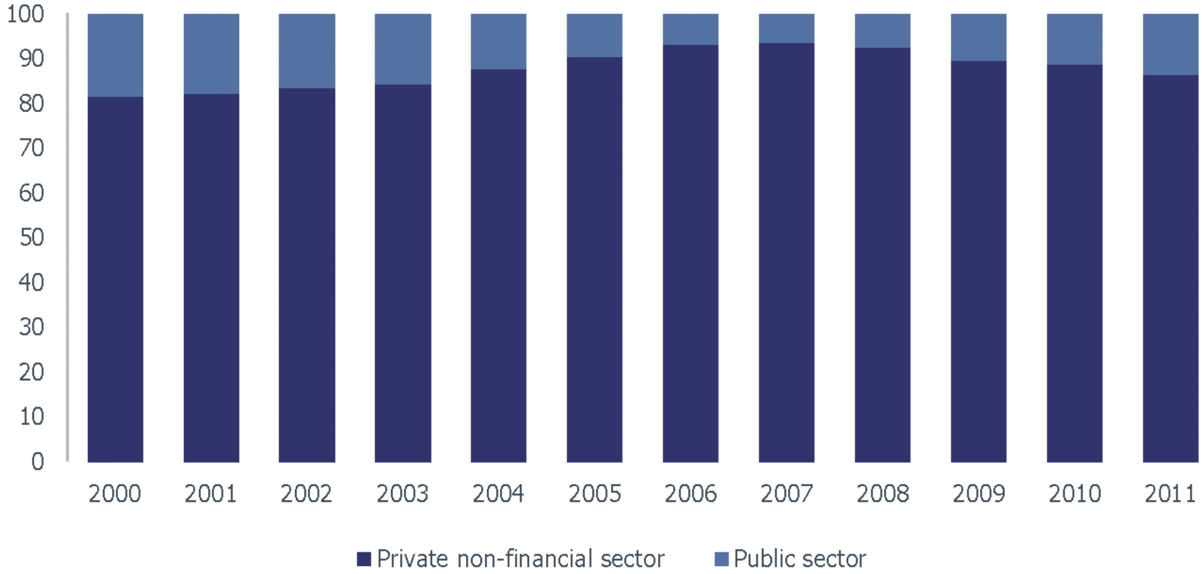
Another point worth analysing in the changes in the composition of financial institutions' business concerns is the way financing has been distributed between the private and public sectors. In the latter case, financing is provided in either of two ways: through the direct granting of loans or through the purchase of government debt.

In the specific case of Spanish credit institutions, Exhibit 5 shows the percentage distribution of bank financing from 2000 to 2011. The time series data clearly show that the economic boom underway up until the end of 2007 was accompanied by rapid growth in lending to the private sector (around 18% a year). Moreover, the public deficit reduction taking place up until 2007 meant that public sector net financing needs decreased (there was even a surplus from 2005 to 2007), which is also reflected in the changing composition of bank financing. In particular, whereas in 2000 the public sector absorbed 18.4% of financing of the Spanish banking sector, in 2007, the percentage had dropped to a third of that amount (6.3%). Subsequently, during the crisis, bank financing of the public sector rose to a maximum of 13.6% in December 2011, explained primarily by the amount of Spanish government debt purchased by the banks. In particular, relative to the 3% of Spanish banks' assets in the form of government debt in 2007, in 2011, the share had risen to 5.8%. The most recent information available at the time of drafting this article refers to February 2012 and situates this percentage at 6.9%, as a result, in particular, of the considerable amount of financing the Spanish banks have received in the ECB's two extraordinary liquidity auctions. As well as

Exhibit 5

Percentage distribution of bank finance of Spanish credit institutions

(%)



Source: Bank of Spain and author's calculations.

meeting debt repayments, Spanish banks have used this finance to buy government debt.

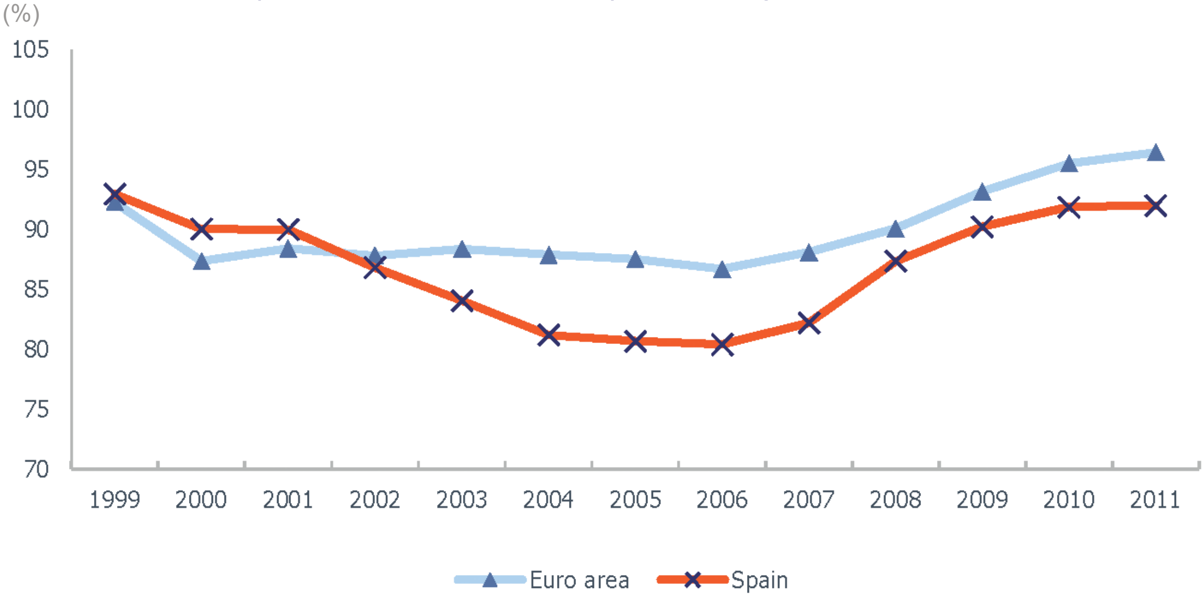
Changes in sources of financing and the liquidity gap

The rapid rate of credit growth in Spain over the period of expansion that lasted up until the onset of the current crisis was possible thanks to the abundance of liquidity in financial markets. However, with the loss of confidence in the wake of the crisis and the closure of wholesale markets (both debt and inter-bank markets), there has been a structural shift, with a reduction in dependence on these markets and consequently greater recourse to bank deposits as the principal form of financing. The ultimate goal of this process was to reduce the credit-deposit liquidity gap and, thereby reduce levels of leverage.

As Exhibit 6 shows, Spanish banks' non-financial private sector deposits-to-loans ratio fell by 10 percentage points between 2000 and 2006 to a minimum of 80.4%. Over this period, European banks' liquidity gap remained relatively constant at around 87%, highlighting Spanish banks' extreme vulnerability to tensions in financial markets. Given the difficulties accessing wholesale markets in the aftermath of the crisis, Spanish banks have had to turn to deposits as a basic financing mechanism. This has translated into a drop of 12 percentage points in the liquidity gap, with the deposits-to-loans ratio reaching 92% in late 2011, a level above even that at the start of 2000. Nevertheless, in 2011, Spain's ratio remained below the European average (92% vs. 96.4%), but exceeded that in countries such as Italy (80%), France (88%) or Portugal (86%). To narrow this liquidity gap, it has been necessary to increase returns on liabilities more than what might be desirable. This has led in recent years to a sharp narrowing of margins, which in turn has had an impact on profits.

Exhibit 6

Deposit/credit ratio (private non-financial sector) of Monetary Financial Institutions



Source: ECB and author's calculations.

Business model and income structure

The different orientation of the banking business towards a particular type of activity is reflected in the composition of the profit and loss account statement, and specifically, in the income structure. Similarly, in addition to the changes in balance-sheet composition, the changes in the structure of the market and the intensity of competition, financial development, internationalisation, financial disintermediation, etc. have effects on the income structure.

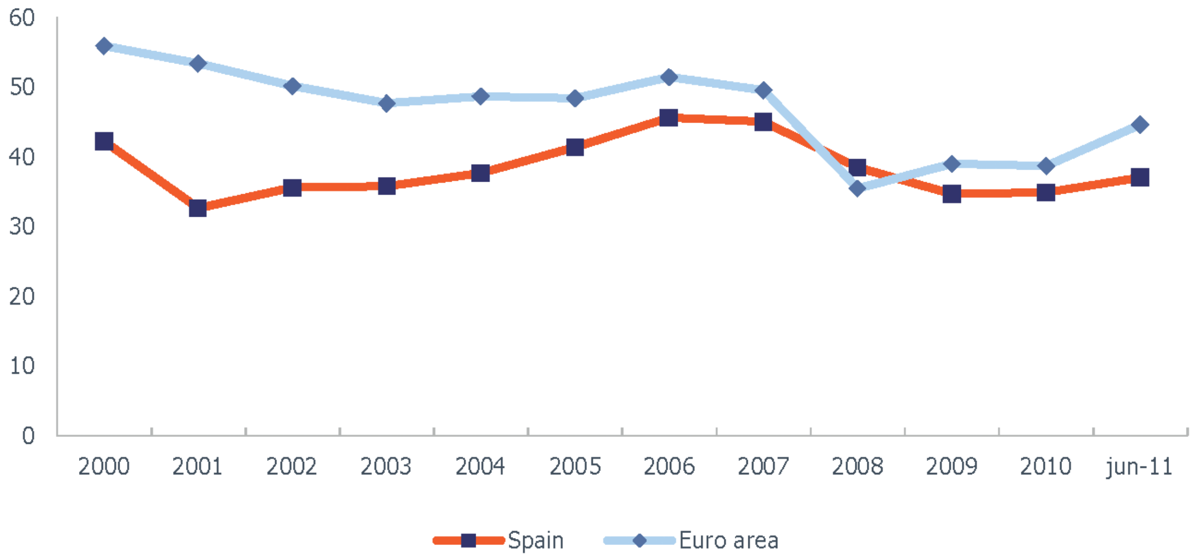
Exhibit 7 shows how the income structure of the Spanish banking sector has developed in comparison to that of banks elsewhere in the euro area, approximated by the weight of non-interest income as a share of total income[2] . The conclusions that can be drawn from the graph are the following: a) throughout almost the whole of the period analysed, the traditional intermediation business characteristic of the Spanish banking sector was reflected in the fact that the weight of net interest income was greater than in the euro area, representing, on average, almost two thirds of net income during the period, as against 50% in the euro area; b) although in early 2000, non-interest income was much less significant in Spain (representing 42.4% of total net income, compared to 55.9% in the euro area), in mid-2011 the difference had narrowed considerably, although interest income continues to be more important in Spain (63% vs. 55.4%); and c) in the wake of the crisis, there has been a structural change in the way the banks' income structure is evolving, with a sharp drop (even sharper in the case of European banks than Spanish ones) in 2008 in the relative importance of non-interest income, from which there has been only a partial and somewhat sluggish recovery in Spain in subsequent years.

[2] Non-interest income includes fee and commissions, income from securities and the net loss/profit on financial operations, and other operating income. Net interest income is financial revenues minus financial costs.

Exhibit 7

Non-interest income/Total net income of Monetary Financial Institutions

(%)



Source: ECB and author's calculations.

Looking to the future

Over the past decade, the Spanish banking sector has undergone a series of significant changes in its specialisation. Nevertheless, it kept its model of retail banking distinct from the international banking model characteristic of the preceding expansionary phase, in which there was a reorientation of the business towards credit origination and subsequent risk transfer (the so-called originate-to-distribute model).

Spanish banks will have to make the advantages associated with their retail (and relationship banking) specialisation compatible with the urgent need to reduce costs and increase efficiency.

However, although at the outbreak of the crisis the originate-to-hold model followed in Spain was initially a strength, the changes in productive specialisation that had taken place with the shift in emphasis onto the property business and the rapid expansion of installed capacity, meant that some of the initial strengths (such as the proximity to customers supported by the extensive network of branches) now need to be revised in order to correct the imbalances that have built up.

What is more, Spanish banks' growing dependence on wholesale finance in the past to fund high levels of credit growth made it necessary to narrow the liquidity gap existing at the time between loans and deposits, which has largely been corrected in response to the closure of wholesale markets. Nevertheless, this replacement of wholesale finance by retail finance has not been cost-free, as it has obliged institutions to increase the yield on liabilities above a desirable level, leading to a narrowing of financial margins, which has had an impact on profits.

Looking to the future, Spanish banks will have to make the advantages associated with their retail (and relationship banking) specialisation compatible with the urgent need to reduce costs and increase efficiency. This is due to the declining growth rate the banking business will suffer in the years ahead as a result of the deleveraging that needs to be undertaken to reduce the economy's high level of private debt. To do so, it will be necessary to reduce excess installed capacity, promote other distribution channels for banking products and services (such as online banking), reorient the business towards other sectors to substitute for the construction business, and increase the share of non-interest income. Last, but not least, once the current restructuring process has been completed, the new and larger institutions emerging will need to look beyond Spain's borders by diversifying their investments geographically, as the evidence shows that it is the more diversified institutions that are best positioned to overcome the crisis.