Resolution of the Spanish banking crisis: Implications of recent developments

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Setting up a clear backstop for losses is one of the most important ingredients necessary to resolve a banking crisis. The 100 billion euros contingent financial assistance approved by the Eurogroup for Spanish banks constitutes, in principle, a sound and credible guarantee. The Memorandum of Understanding (MoU), establishing the conditions to receive EU financial aid, provides a new roadmap. Apart from specific requirements for Spanish banks, the advances towards a European banking union will affect the way in which the final resolution of the Spanish banking crisis is achieved.

There has been some recent progress in the resolution of the banking crisis in Spain through four major developments. First, the Eurogroup agreed on setting up contingent aid for the recapitalization of Spanish banks for 100 billion euros. Second, two well-known consulting firms performed the first independent valuation of Spanish banks' capital needs. Third, the Eurozone members took some very relevant decisions during their June 28th-29th meeting that could potentially alleviate market pressures on Spanish banks by defining a more streamlined approach for channeling the recapitalization of banks in the Eurozone. Some of these changes point to a European banking union in the near future. And finally, the Memorandum of Understanding (MoU,) with the conditions set for European financial aid for Spanish banks, has also been released on July 20th.

The Eurogroup's financial assistance: A backstop for Spanish banks

On June 9th, 2012, the Eurogroup published a statement in which they set up contingent financial aid for the recapitalization of Spanish banks for 100 billion euros. The aid was defined as a "loan amount" that "must cover estimated capital requirements with an additional margin of safety".

Importantly, following the formal request for aid by the Spanish authorities –effectively made last June 25th - an assessment needs to be provided by the European Commission, the European Central Bank, the European Banking Authority and the International Monetary Fund. The conditionality is embedded in a Memorandum of Understanding (MoU) that we analyze later in this document.

As specified in the Eurogroup statement, the financial assistance is expected to be provided by the European Financial Stability Facility (EFSF) or the European Stability Mechanism

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(ESM). Importantly, the Spanish government was expected to retain the full responsibility of the financial assistance. Additionally, the Eurogroup considers that the policy conditionality of the financial assistance should be "focused on specific reforms targeting the financial sector, including restructuring plans in line with EU state-aid rules and horizontal structural reforms of the domestic financial sector."

Given the initial conditions expressed in the Eurogroup statement, the backstop was accompanied by some uncertainty regarding three issues:

i) To what extent the EU funding assistance would be considered as senior debt relative to the Spanish sovereign. The consideration of EU funding assistance as senior debt could potentially harm sovereigns such as Spain, as its banks would then rank behind official EU creditors in terms of debt subordination. At the time the statement was released, this issue was not clear. The rules of the ESM provide it with preferred creditor status, junior only to the International Monetary Fund. In this sense, it will also be very important to determine whether the funds will be channeled in the form of CoCos or whether they will be provided directly as equity capital.

ii) To what extent the intermediation of the FROB would imply that the financial assistance might eventually increase public debt and/or deficit.

iii) What type of conditionality will be imposed on the Spanish banking sector.

While these issues have not yet been totally clarified and important market tensions –with country risk significantly increasing- remained for Spain during June 2012, the Summit held by the Eurozone members on June 29th helped reduce part of the uncertainty. The three main agreements reached had relevant implications for Spain and its financial institutions.

First, there was a fundamental decision made by allowing the ESM to have the possibility to recapitalize banks directly. This would eventually eliminate the intermediation of States in the recapitalization of banks so that the funds provided to these banks would not be considered as public debt or deficit. This new role of the ESM is conditional on the establishment of a single *"supervisory mechanism -involving the ECB- for banks in the euro area*". Hence, there is also a commitment to set up a European banking union in a relatively short time period. Additionally, any direct recapitalization of banks by the ESM would also involve a number of conditionality terms to be determined on a case by case basis. Since Spain will probably be the first country to benefit from the direct recapitalization of banks, it seems that the Spanish case will be very relevant to lay the foundation for the Eurozone banking union.

Powers will be transferred to the ESM without gaining seniority status with respect to other types of debt. As a result, debt subordination will apparently not be an issue for the recapitalization of Spanish banks with EU funding.

Second, the statement of the Eurozone members *"urge the rapid conclusion of the Memorandum of Understanding attached to the financial support to Spain for recapitalization of its banking sector."* The financial assistance will be provided by the EFSF until the ESM becomes available. Subsequently, powers will be transferred to the ESM without gaining seniority status with respect to other types of debt. As a result, debt subordination will apparently not be an issue for the recapitalization of Spanish banks with EU funding.

Finally, the statement refers to *the "strong commitment to do what is necessary to ensure the financial stability of the euro area".* The aim would be using the EFSF/ESM to stabilize markets. The way has yet to be defined but this may help

Spain and its banks –as well as other European countries- reduce the upwards pressures on sovereign yields.

The independent valuations of the capital needs of the Spanish banking sector: Stress test approach

As the main terms of the EU financial assistance for Spanish banks were being defined, the valuations of two private consulting companies, Roland Berger and Oliver Wyman - commissioned by the Spanish government to undertake an independent assessment of the capital needs of the Spanish banking sector - were published on June 21st.

The objective of this first independent assessment was to undertake a stress tests *"to offer an estimate of the aggregate capital needs for the Spanish banking system as a whole under two different macroeconomic environments: one of them a baseline, considered the most likely scenario, and an alternative severely stressed scenario".* This assessment is considered preliminary by the Spanish government, as there is another valuation that has been commissioned to produce bank-level estimations of these capital needs. However, these individual bank valuations are expected to be released in September.

Importantly, the two external consultants have worked independently from each other. The assessment has been made using data of the largest 14 banking groups in Spain. The governance of the exercise has been entrusted to a Steering Committee -controlled by the Spanish government and the Bank of Spain- with an advisory panel comprised by the following members: the ECB, the IMF, the EC and the EBA.

The two scenarios considered in the assessment are shown to be tougher than those of the IMF as recently used in its Financial Sector Assessment Program.

The two scenarios considered in the assessment (predefined by the Steering Committee) –which are summarized in Exhibit 1- are shown to be

Exhibit 1

Macroeconomic scenarios for the assessment of the Spanish banking sector

Annual growth rates										
	IMF (FSAP)				External consultants					
	2012		2013		2012		2013		2014	
	Baseline	Adverse	Baseline	Adverse	Baseline	Adverse	Baseline	Adverse	Baseline	Adverse
Real GDP	-1.7	-4.1	-0.3	-1.6	-1.7	-4.1	-0.3	-2.1	0.3	-0.3
Unemployment Rate (1)	23.8	25.0	23.5	26.6	23.8	25.0	23.5	26.8	23.4	27.2
Housing Prices	-5.6	-19.9	-2.8	-3.6	-5.6	-19.9	-2.8	-4.5	-1.5	-2.0
Madrid Stock Exchange Index	-1.3	-51.3	-0.4	-0.4	-1.3	-51.3	-0.4	-5.0	0.0	0.0
Credit to Other Resident Sectors										
- Households	-3.8	-6.8	-3.1	-10.5	-3.8	-6.8	-3.1	-6.8	-2.7	-4.0
- Non-Financial Firms	-5.3	-6.4	-4.3	-3.0	-5.3	-6.4	-4.3	-5.3	-2.7	-4.0

Source: Bank of Spain and own elaboration

tougher than those of the IMF as recently used in its Financial Sector Assessment Program. The macroeconomic projections are particularly harsh in the case of GDP growth, assuming, for example a 4.1% fall in 2012 under the adverse scenario. However, other assumptions, albeit tough, can be considered as more realistic in our opinion, including an accumulated fall in house prices of 24.4% during 2012-2013, or nominal reductions in lending to the private sector of around 5-6% yearly.

The 14 Spanish banking groups considered represent almost 90% of the Spanish financial system: Santander, BBVA + Unnim, Popular + Pastor, Sabadell + CAM, Bankinter, Caixabank + Cívica, Bankia-BFA, KutxaBank, Ibercaja + Caja3 + Liberbank, Unicaja + CEISS, Banco Mare Nostrum, CatalunyaBank, NCG Bank, Banco de Valencia.

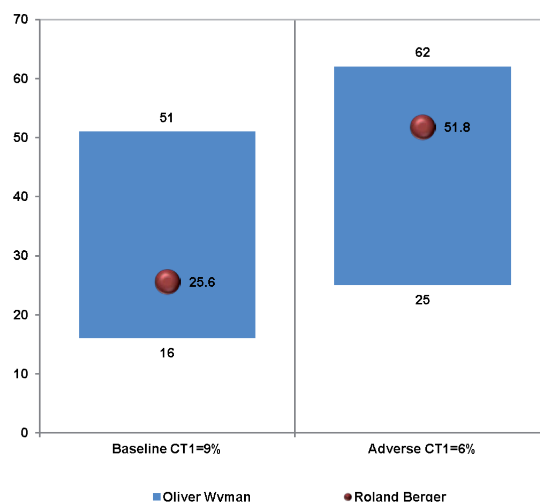
Compared to other previous stress tests –for example, those implemented by the European Banking Authority in 2011–the stress tests of the two independent auditors incorporate, at least, an important new ingredient. In particular, the analysis is applied to all the loans to the resident private sector, including real estate assets, and not only to the real estate and construction loan portfolio. Hence, other loans such as SME loans or retail mortgages have also been considered as potentially problematic.

As for the results, they are summarized in Exhibit 2. Oliver Wyman has given an interval of potential capital needs for each one of the two scenarios, while Roland Berger has given a specific estimation for each one of the two scenarios. In the worst-case-scenario, the capital needs are estimated at 62 billion euros. This is well below the backstop of 100 billion euros provided by the EU.

It is difficult to determine to what extent these estimations will contribute to reduce the uncertainty on the magnitude of the actual and potential asset

Exhibit 2

Estimated capital needs (billion euros)



Source: Bank of Spain and own elaboration

impairment of Spain. Among the most positive features of the estimations, both auditors have considered a sound and reasonable framework to estimate some basic ingredients of bank losses and capital needs, such as the probability of default (PD), the loss-given default (LGD) and the exposure at default (EAD) for different loan portfolios. The reliability of the estimations also benefitted from the use of a larger base of risk-weighted assets (RWA) by considering not only real estate-related loans but also other loans to the private sector. For example, Roland Berger estimates losses of 17 billion euros from the mortgage portfolio.

In any case, some sources of uncertainty will probably remain until the results of the asset-by-asset valuation at the individual bank level are presented in September. One of the reasons is that the two auditors have used the same loan portfolio classification that the Bank of Spain has been using and it is difficult to assess, for example, the role that loan refinancing transactions may have on asset impairment.

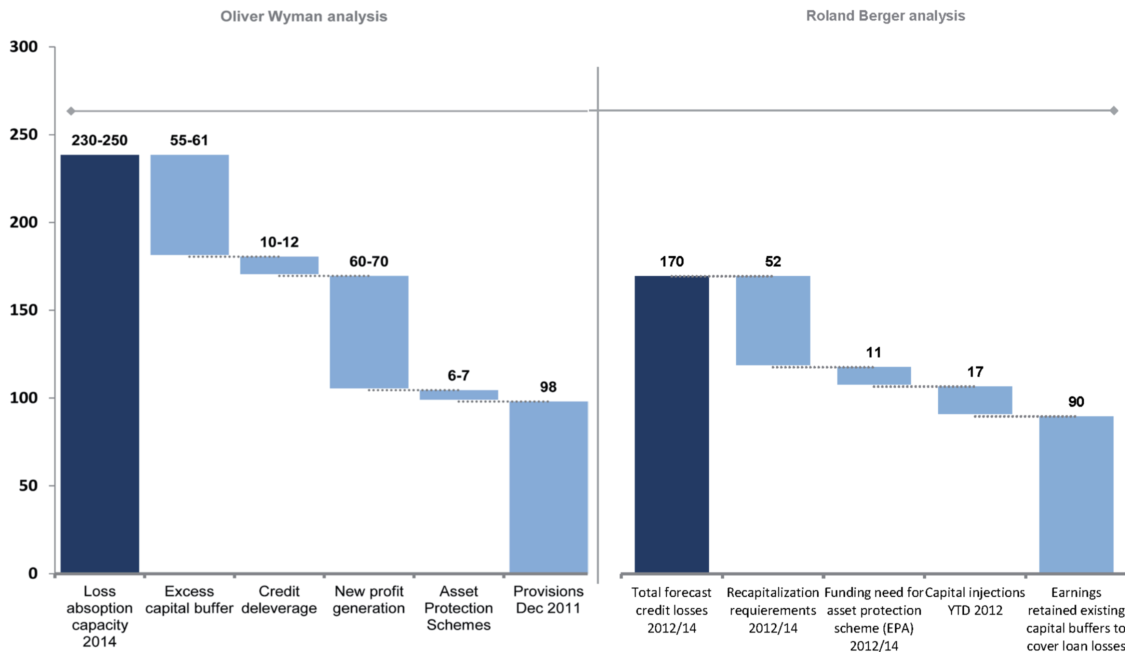
A very relevant feature is the loss-absorption capacity of the Spanish banking sector that both consulting firms estimate. A summary of the different sources of loss-absorption capacity is shown in Exhibit 3.

The estimations of credit losses by Oliver Wyman are substantial in the adverse scenario (250-270 billion euros). However, as shown in Exhibit 3 they estimate a considerable loss-absorption capacity of 230-250 billion euros. In the case of Roland Berger, total losses are estimated around 150-170 billion euros. The differences between the auditors´ results are mostly explained by the fact that Oliver Wyman considers all the provisions and losses made as of December 2011, while Roland Berger only considers the remaining provisions to be made and losses to be covered. Some commentators (i.e. Bloomberg in its July 2nd article "Spain Overestimating Bank Profit Risks Seeking Too Little") already suggest that the estimation of the loss-absorption capacity is a bit optimistic.

An alternate view suggests that the provisioning efforts that have already been made by Spanish financial institutions have already covered a great deal of the asset impairment. For example, the Roland Berger report mentions that "retained earnings, loan loss provisions and existing capital buffers cover 54% of overall forecast credit

Exhibit 3

The estimated loss-absorption capacity of the Spanish banking sector (billion euros)



Notes:

a) Capital Buffer considered over capital requierements of 6 % core tier 1 ratio
b) Estimated by RBSC
c) Provided by BdE
d) Not including provisions for NPL 2011 and earlier, capital buffers in excess of 6% core tier 1 ratio
e) Earnings retained by banks in order to cover forecast credit losses

Source: Bank of Spain and own elaboration

losses. Capital injections year-to-date 2012 cover 10% (16.5 billion euros), the asset protection scheme covers 6% (10.5 billion euros) and the 51.8 billion euros recapitalization requirement covers 31%." Again, it seems that only the bank-level assessment of the asset impairment could clarify if the loss-absorption capacity has been underestimated or overestimated.

A drawback of an overall valuation of the banking sector is that it does not help make the necessary distinction between those institutions that do not need any or little capital and those in need of significant amounts of capital.

There are some other features that accompanied this first assessment of the banking sector which also deserve some attention. In the presentation of the stress tests, the government and Bank of Spain/FROB representatives specified that:

- The competitive bidding processes for the nationalized banks have been postponed until the conditions imposed on the banking sector attached to the EU financial assistance are defined, and the recapitalization needs of Spanish banks are estimated at the bank-level.
- The banks that require additional capital will have to deliver a recapitalization plan in September. Those that present a "credible" plan for their own recapitalization (without external aid) will have nine months to implement it.
- Some recent recommendations of the IMF and the EC might be considered to segregate the impaired real estate assets from banks' balance sheets and to provide mark-to-market valuations.
- The provisions required by the two banking reforms of 2012 (Royal-Decree 2/2012 and Royal Decree 18/2012) are still applicable. Actually, the projections of the loss-absorption capacity made by the two consulting companies consider that those provisions will be one of the instruments used to meet the capital requirements.

The MoU: Conditions for a new roadmap

On July 20th, 2012, the Spanish government signed a MoU on "financial-sector policy conditionality" establishing specific measures to reinforce financial stability in Spain associated with the financial support provided to Spanish banks. The main objective of the MoU is said to " increase the long-term resilience of the banking sector as a whole, thus, restoring its market access." The MoU text is complemented by two documents that specify some general conditions of the financial assistance to Spain, the "Master financial assistance facility agreement" and the "Terms of Reference for IMF Staff Monitoring"[3].

In practical terms, the MoU seeks to overhaul the weak segments of the Spanish financial sector by identifying the capital needs following an asset-by-asset stress test, recapitalizing (or "restructuring or resolving") the weak banks, and segregating the assets of the banks receiving aid for recapitalization by transferring their impaired assets to an asset management company (AMC).

The MoU follows a roadmap describing a progressive implementation of measures from July 2012 to June 2013. In July 2012, a first tranche of funds for recapitalization is supposed to be provided, since the MoU assumes that the announcement itself of recapitalization aid may put some Spanish banks at risk until the

[3] All the legal documents of the EU financial assistance to Spanish banks can be downloaded at: http://www.mineco.gob.es/portal/site/mineco/.

recapitalization is completed. This first tranche of aid is 30 billion euros. If these funds are employed, the Bank of Spain will have to make an official request that would be eventually approved by the European Commission (EC), the Euro Working Group (EWG) and the ECB.

In September 2012, it is expected that the asset-by-asset stress tests of Spanish banks will be ready and that a bank-level estimation of the capital shortfalls will be provided. Importantly, these stress tests will give rise to a classification of banks into four groups:

- Group 0: Banks showing no capital shortfall.
- Group 1: Nationalized banks, including BFA/Bankia, Catalunya Caixa, NCG Banco and Banco de Valencia.
- Group 2: Banks with capital shortfalls and in need of help to address the necessary recapitalization.
- Group 3: Banks with capital shortfalls but with credible recapitalization plans allowing them to meet these capital shortfalls through private funding sources.

By early-October, banks in Groups 1, 2 and 3 will be required to present recapitalization plans, including the possibility of asking for EU aid. For the nationalized banks, the Spanish authorities and the European Commission will work with the institutions in preparing the recapitalization plans from July 2012 onwards. These plans should be approved by November 2012 and should include the transfer of impaired assets to an AMC by year end.

The recapitalization plans for Group 2 banks must be ready by October 2012 and they are expected to be approved by year end, along with decisions regarding whether to “recapitalize” or “resolve” the banks. These banks will also be also required to include the segregation of their impaired assets to an AMC.

As for Group 3 banks, the possibilities are a bit wider. Those banks planning to significant increase equity, more than 2% of RWA, will, as a precautionary measure, be required to issue contingent convertible securities (COCOs) to meet their capital needs by year end. These COCOs will be subscribed for by the FROB (using EU aid funds) and may be redeemed until June 30th, 2013, if the banks raise the necessary capital from private sources. If these banks do not get the private funds to redeem the COCOs, the COCOs will be totally or partially converted into ordinary shares. Banks in Group 3 may also plan a more limited equity increase of less than 2% of RWA. These banks will have until June 30th, 2013, to raise this equity. If they do not get the necessary equity, they will be subject to new recapitalization and restructuring plans by Spanish and EU authorities. In general, those banks in Group 3 that still benefit from any kind of public support by June 30th, 2012, will be required to transfer their impaired assets to an AMC.

In parallel to these recapitalization terms, a very relevant issue in the MoU is the establishment of a burden sharing exercise. In particular, in order to minimize the cost to taxpayers of bank restructuring, not only equity holders will suffer the bank losses. A burden sharing from hybrid capital holders and subordinated debt holders will also be required for any bank receiving EU financial aid. This burden sharing can be either voluntary or mandatory through the so-called Subordinated Liability Exercises (SLEs).

To meet this intense program, the MoU has included more specific conditionality terms through 32 measures, which are specified in Appendix 2 of the memorandum. To summarize them, we have classified these conditions into three groups (the number corresponding to each of the conditions is shown in parentheses and they are not necessarily correlative):

a. Preparation and evaluation issues: (1) Provide data needed for monitoring the entire banking

sector and of banks of specific interest due to their systemic nature or condition; (2) Prepare restructuring and resolution plans with the EC for Group 1 banks, to be finalised in light of the Stress Tests results in time to allow their approval by the Commission in November; (3) Finalise the proposal for enhancement and harmonization of disclosure requirements for all credit institutions on key areas of the portfolios such as restructured and refinanced loans and sectoral concentration; (4) Provide information required for the Stress Test to the consultant, including the results of the asset quality review; (5) Introduce legislation to ensure the effectiveness of SLEs, including to allow for mandatory SLEs; (6) Upgrade of the bank resolution framework, i.e. strengthen the resolution powers of the FROB and Deposit Guarantee Fund (DGF); (7) Prepare a comprehensive blueprint and legislative framework for the establishment and functioning of the AMC; (8) Complete bank-by-bank stress tests (Stress Tests); (9) Finalise a regulatory proposal on enhancing transparency of banks.

b. Burden sharing and recapitalization: (10) Banks with significant capital shortfalls will conduct SLEs before capital injections; (11) Banks to draw up recapitalization plans to indicate how capital shortfalls will be filled; (12) Present restructuring or resolution plans to the EC for Group 2 banks; (13) Identify possibilities to further enhance the areas in which the Bank of Spain can issue binding guidelines or interpretations without regulatory empowerment; (14) Conduct an internal review of supervisory and decision-making processes. Propose changes in procedures in order to guarantee timely adoption of remedial actions for addressing problems detected at an early stage by on-site inspection teams. Ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses; (15) Adopt legislation for the establishment and functioning of the AMC in order to make it fully operational by November 2012; (23) Issues of CoCos under the recapitalization scheme for Group 3 banks planning a significant (more than 2% of RWA) equity increase; (26) Require all Spanish credit institutions to meet a Common Equity Tier 1 ratio of at least 9% until at least end-2014. Require all Spanish credit institutions to apply the definition of capital established in the Capital Requirements Regulation (CRR), observing the gradual phase-in period foreseen in the future CRR, to calculate their minimum capital requirements established in the EU legislation; (31) Raise the required capital for banks planning a more limited (less than 2% of RWA) increase in equity; (32) Group 3 banks with CoCos to present restructuring plans.

c. Governance and transparency issues: (16) Submit for consultation with stakeholders envisaged enhancements of the credit register; (17) Prepare proposals for the strengthening of non-bank financial intermediation including capital market funding and venture capital; (18) Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding governing bodies of former savings banks and commercial banks controlled by them; (19) Provide a roadmap (including justified exceptions) for the eventual listing of banks included in the stress test which have benefited from state aid as part of the restructuring process; (20) Prepare legislation clarifying the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reducing their stakes to non-controlling levels. Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Provide a roadmap for the eventual listing of banks included in the Stress Test, which have benefited from State aid as part of the restructuring process; (21) Banks to provide standardized quarterly balance sheet forecasts funding plans for credit institutions receiving state aid or for which capital shortfalls will be revealed in the bottom-up stress test; (22) Submit a policy document on the amendment of the provisioning framework if and once Royal Decree Laws 2/2012 and 18/2012 cease to apply. Mid - December

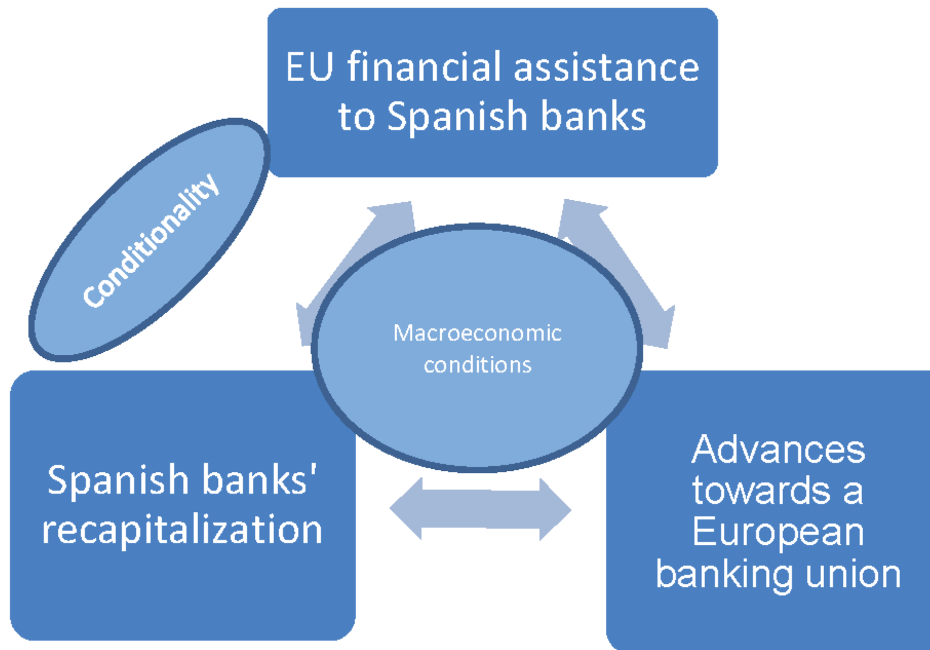
2012; (24) Transfer the sanctioning and licensing powers of the Ministry of Economy to the Bank of Spain; (25) Require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments; (27) Review governance arrangements of the FROB and ensure that active bankers will not be members of the Governing Bodies of FROB; (28) Review the issues of credit concentration and related party transactions; (29) Propose specific legislation to limit the sale by banks of subordinate debt instruments to non-qualified retail clients and to substantially improve the process for the sale of any instruments not covered by the deposit guarantee fund to retail clients; (30) Amend legislation for the enhancement of the credit register.

As for the document entitled "Master financial assistance facility agreement", it sets some general conditions for the participation of the EFSF in the financial assistance of Spanish banks which is considered a "Bank Recapitalization Facility". Importantly, the average maturity of the Bank Recapitalization Facility "shall not exceed twelve point five (12.5) years and the maximum maturity of any individual disbursement of Financial Assistance is fifteen (15) years".

As for the cost of the funds, this is established as a variable interest rate to be determined for each of the so-called "interest periods" which are defined as "the first Interest Period and each consecutive twelve (12) months period thereafter, commencing on (and including) the date of the preceding payment date for the financial assistance."

Exhibit 4

Spanish banks' recapitalization, the EU financial assistance and the advances towards the European banking union



Source: Authors' own elaboration

As for the document showing the terms of the participation of the IMF in the financial assistance of Spanish banks, the "Terms of Reference" establishes that the purpose of IMF staff is technical monitoring, which consists of providing independent advice. These terms establish that the IMF is not responsible for the conditionality or implementation of the MoU terms.

Challenges ahead: Spanish bank recapitalization within a European banking union

The advances described in the previous sections seem to be critical steps towards the establishment of appropriate resolution mechanisms for the banking crisis in Spain. However, there are various important challenges ahead for both Spanish and European authorities –as well as for the financial sector- over the next few months.

The bank-level valuation of the recapitalization needs of Spanish banks in September will provide a reference point to decide the necessary amount of funds for Spanish banks as well as the roadmap to finalize the cleaning-up of Spanish banks' balance sheets.

As shown in Exhibit 4, the recapitalization process in Spain will be largely determined by the way the EU financial assistance, and the whole process of recapitalization and banking crisis resolution interact with the advances towards the establishment of a European banking union.

On June 6th, 2012, the European Commission adopted a proposal for "EU-wide rules for bank recovery and resolution". This includes a draft of an EU directive with interesting reflections, recommendations and potential rules towards a European Banking Union. Since some Spanish banks will likely be the first recipients of EU financial assistance within such a union, some of the issues under discussion in this proposal may be particularly relevant for Spain in the near future. The proposal considers a framework for resolution that will require banks to draw up recovery plans setting out measures that would kick-in in the event of a deterioration of their financial situation in order to restore their viability.

Banks are required to prepare resolution plans with options for dealing with banks in critical condition, which are no longer viable. The draft proposal also refers to a "bail-in" tool whereby the bank would be recapitalized through shareholders being wiped out or diluted, and through creditors having their claims reduced or converted into shares. This is a particularly sensitive issue in the case of Spanish banks, where preference shares' investors may be affected by such a "bail-in" policy.

At this stage, it is difficult to determine how a European banking union may evolve over the next months and to what extent it will influence the way Spanish banks complete their recapitalization process. The conditions established in the Memorandum of Understanding by EU authorities and the IMF in exchange for financial assistance will be a first illustrative guideline of the terms that any financial system in Europe may have to comply with to benefit from such a union. This will require that Spanish authorities make an additional effort to set a definitive timing and road map to complete the resolution of the banking crisis in Spain. The development of the European banking union in parallel may introduce some difficulties, but it may also be an opportunity to make this resolution effective as soon as possible.