The wholesale funding market of the Spanish banking system

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Market jitters over high debt levels are making it increasingly difficult for Spanish credit institutions to meet their financing needs in the wholesale markets. ECB liquidity is providing short-term support but a longer-term, credible solution involving: i) clarity on the banking recapitalization process, ii) clean-up of bank balance sheets, iii) a definitive roadmap for the future of the Eurozone; and, iv) further transparency measures in order to enhance risk identification and crisis management mechanisms is needed to secure access to traditional funding sources.

Spain's high levels of private debt, in particular bank debt, together with increased public debt levels, is making it extremely difficult for Spanish banks to tap wholesale funding markets-currently their main source of funding. Such difficulties have essentially led banks, and to an even greater degree cajas, to rely on shorter-dated, secured debt instruments. However, in the actual context of greater risk aversion for peripheral Eurozone countries, only the Spanish Treasury is successfully able to raise money in the primary market. Temporary ECB liquidity support measures have provided some necessary breathing space for the Spanish financial system. But, Spanish credit institutions must recover the confidence of the markets and come back to traditional funding channels in order to reduce their heavy dependence on Eurosystem liquidity.

Wholesale funding in the Spanish banking system

The Spanish ratio of private debt to GDP is one of the highest among the countries of the Euro Zone, as shown in Exhibit 1. In fact, Spain´s ratio or private debt to GDP is higher than 225%, only lower than Ireland and Portugal. Most of this debt was originated by the Spanish banking sector in the form of fixed income securities, which account for more than 520 billion euros. The high level of Spanish bank debt, alongside the increase in the amount of Public Debt, are among the main reasons why traditional investors in Spanish sovereign and bank debt are reluctant to continue investing in these asset classes.

The spanish financial System has modernized significantly during the past decade, which has been especially true in the case of savings banks or "cajas". This has resulted in a diversification of funding sources and also in greater reliance on

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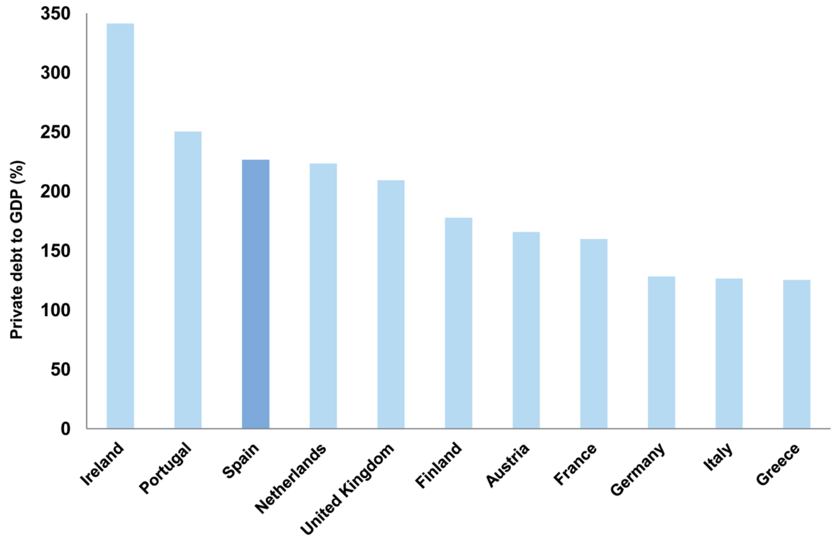
Exhibit 1

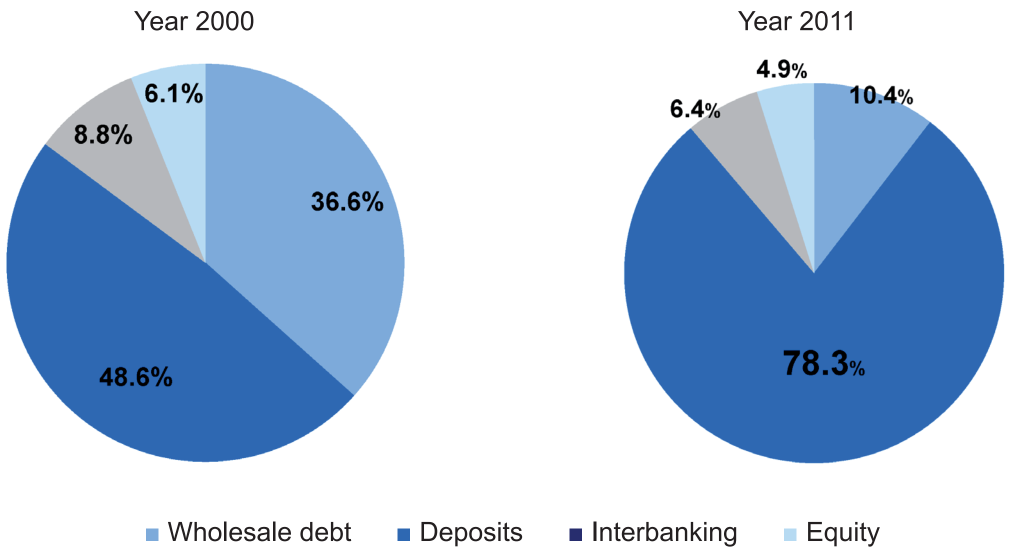
Breakdown by country of private debt to GDP



Source: AFI from Eurostat

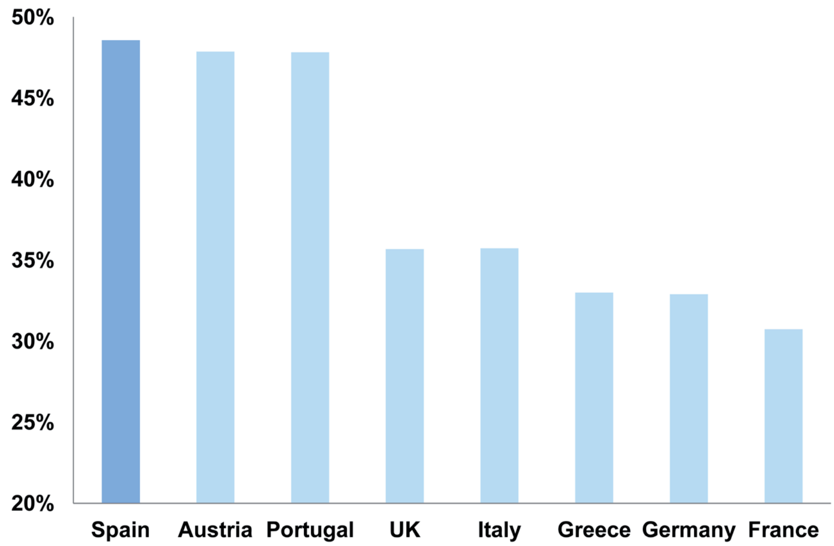
Exhibit 2

Breakdown by outstanding amount of financing instruments of the Spanish banking sector



Source: AFI from AEB and CECA

Exhibit 3
Breakdown by country of percentage of retail deposits to total assets



Source: AFI from FACTSET, AEB and CECA

the wholesale funding market. Whereas during 2000, retail funding accounted for 74.6% of total liabilities, by 2011, this figure had decreased to only 48.6%, approaching the funding structure observed within other European countries. Consequently, the closure of wholesale funding markets has affected the liquidity position of many Spanish financial institutions. ECB aid has only partially compensated for the damage.

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Despite increasing reliance on wholesale funding, the Spanish banking sector is still significantly well-supported by retail deposits – the deposit base for Spanish credit institutions is, on average, higher than the European banking system average–. Nevertheless, since convergence is clear, Spanish institutions are, and will continue to be, exposed to the needs and volatility of the funding markets.

Debt stock breakdown by collateral and maturity

As stated previously, Spain´s private debt to GDP levels are high in comparison with other European countries. Most of the private debt of the Spanish system has been issued by the banking sector (not only by banks, but also by cajas). As recent figures shows, Spanish bank debt in the form of fixed income instruments (loans and other kinds of banking liabilities excluded) is larger than 520 billion euros; most of this debt has been issued in wholesale markets. In comparison, this amount is slightly below the amount of Spanish Treasury debt, which is roughly 600 billion euros.

There are no accurate and reliable figures for Spanish bank debt composition because a part of the issuance (basically the private issuance) is not subject to registration requirements in a regulated market (neither in Spain nor in other countries). Apart from these exceptions, Afi estimates that almost 90% of the total debt of the banking system has been issued in the wholesale market and the remaining 10% channelled through the retail market.

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The Spanish banks´ debt market is very heterogeneous with respect to the type of collateral issued to back the instruments. The most widely used types of instruments in the wholesale market are secured instruments (Spanish covered bonds –cédulas hipotecarias– and government guaranteed bonds), almost 55% of the bank debt market. The rest of their debt is split between unsecured senior debt (35% of the total outstanding amount) and subordinated debt (preferred, junior subordinated and subordinated debt), which, according to Afi's estimates, could reach up to 10% of the total amount. Securitizations and other asset-backed funding products have a residual weight in the composition of the liabilities structure of Spanish banks.

Apart from the different percentages of issuance per type of collateral, there are also some differences with respect to in which markets the debt has been placed. The secured debt has almost entirely been distributed in the wholesale markets (98% according to Afi's estimates). The senior unsecured debt has mainly been placed in the wholesale market too (95% according to the same source). On the contrary, subordinated debt has been mainly channelled through the retail market (65% approx.)

Exhibit 4

Breakdown by market of the overall outstanding amount of debt of the Spanish banking sector

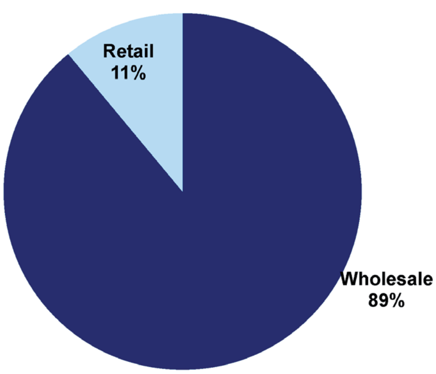
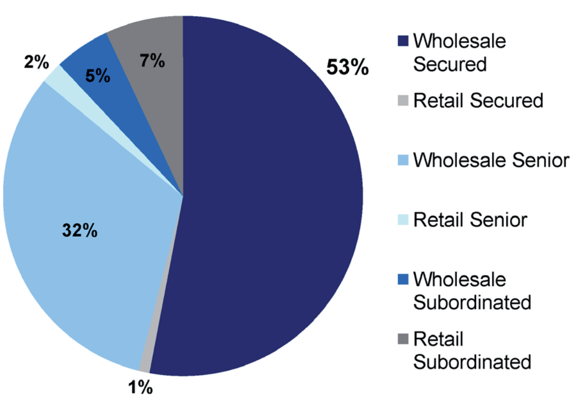


Exhibit 5

Breakdown by market and collateral of the overall outstanding amount of debt of the Spanish banking sector



Source: AFI from various sources

The differences in the wholesale funding profile rely not only on collateral analysis, but also on the issuer´s debt composition (banks or cajas). Basically, these differences could be summarized in two aspects: (i) the kind of debt issued, and (ii) maturity profile of the debt.

The profile of Spanish bank debt maturities is biased to the short term. This bias is very common in both, private entities and the public sector. In the case of the Spanish banks, the maturities until December 2013 reach 125 billion euros, which is approximately 25% of the total debt issued in the wholesale market. In the next three and a half years (until December 2015), the amount of debt maturing will rise to close to 340 billion euros.

We should not forget the combined analysis of maturities by type of collateral and type of issuer tapping the market. The main form of instrument issued in the wholesale market by both banks and cajas has been secured instruments (cédulas hipotecarias and/or government guaranteed bonds), which is in line with the high importance of secured debt as a percentage of the total outstanding amount of debt of the Spanish banking system.

However, the short and medium term debt maturity distribution is very different between banks and cajas. In general, contrary to the case of banks, cajas have a more medium term debt maturity bias. Additionally, the amount of cajas´ debt maturating through 2015 is heavily concentrated in secured debt (Exhibit 8), while in the case of banks, this percentage is much lower, but also non-negligible, around 60% (Exhibit 7).

This difference in maturity profile among banks and cajas is due to both their different business plans and assets size, much lower in the case of the savings banks. The smaller size of the cajas prompted them to use covered bonds as their main funding instrument.

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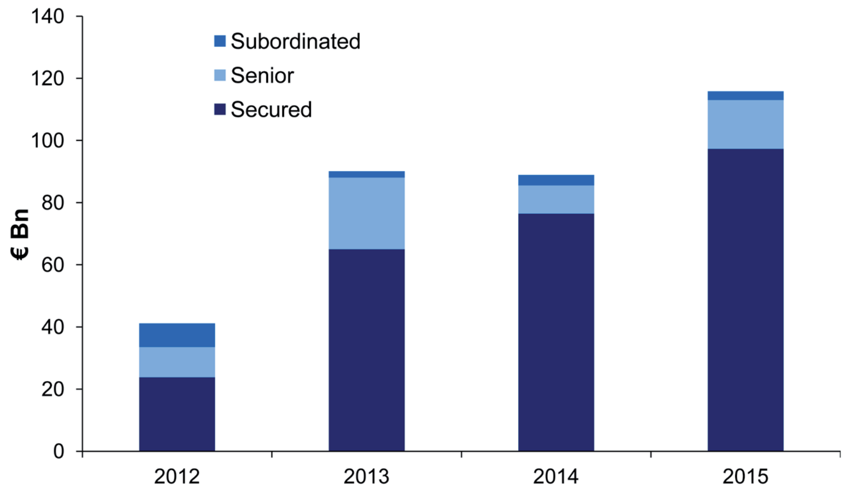
Exhibit 6

Breakdown by maturity and collateral of the overall outstanding amount of debt of the Spanish banking sector



Source: AFI from various sources

plans and assets size, much lower in the case of the savings banks. The smaller size of the cajas prompted them to use covered bonds as their main funding instrument. There are two important reasons for this. First, because cajas have maintained close linkages with the real estate market, so they disposed of a large amount of collateral to issue cédulas hipotecarias. Second, because, due to their discreet presence in the wholesale arena, the main way to place bonds in the market has been through secured instrument, as cédulas (multicédulas normally) or as government guaranteed bonds (whose maturities are concentrated between the years 2012 and 2016). Therefore, according to Afi's estimates, almost 70% of the outstanding amount of the debt issued by cajas is secured.

There is a difference in composition of the maturity profile of the senior unsecured debt markets. The weight of this kind of debt for banks that matures within the next 5 years is around 31%, while in savings banks, it hardly reaches 9%. Obviously, the greater capacity of the banks to finance themselves in wholesale markets has been a crucial element to place more unsecured bonds compared to cajas.

Finally, subordinated debt represents a residual amount of the maturities of the cajas until 2016 (2%) and 9% in the case of the banks.

Current situation in the wholesale funding markets for Spanish banks

The rise in risk-aversion for Eurozone peripheral countries has resulted in an increase of their spreads relative to their core peers. This has affected not only sovereign, but also corporate issuers.

The rally in sovereign interest rates has prevented most peripheral issuers –with few exceptions such as Intesa Sanpaolo that recently placed 1 billion euros in the unsecured primary market– from tapping wholesale funding markets. Basically, only some national Treasuries have been able to issue in the primary market, assuming a surge in funding costs.

For private issuers (including banks in the periphery) and since the beginning of the crisis, distinct periods have been observed regarding wholesale funding. During periods of lower risk

Exhibit 7

Breakdown by maturity and collateral of the overall outstanding amount of debt of the Spanish banks

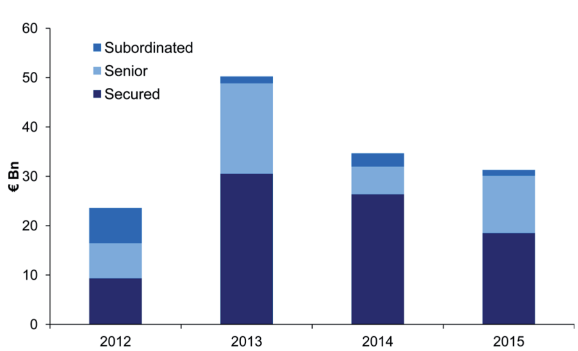
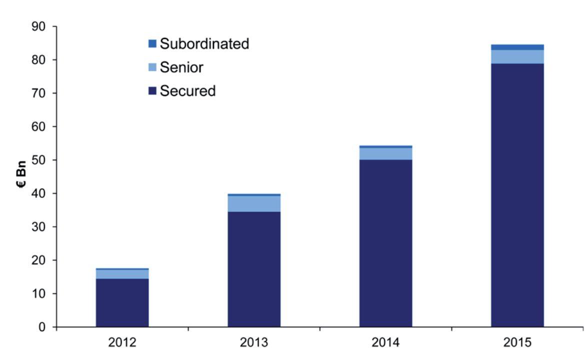


Exhibit 8

Breakdown by maturity and collateral of the overall outstanding amount of debt of the Spanish cajas



Source: AFI from various sources

aversion, spreads narrowing and less pressure on periphery financial assets, banks have managed to tap primary markets. However, these low-risk aversion windows have sometimes occurred during periods of greater stress in the financial markets, resulting in a null probability for banks to place debt in wholesale markets. In the case of Spain, the only agent that has been capable of maintaining its issuance program (not without some problems) has been the Treasury –and the Spanish Official Institute of Credit (ICO in its Spanish initials) to some extent. Other public or private issuers have been unable to raise funds in the primary market.

These periods share some common elements. The trigger for the first period to start is a significant reduction in spreads. Additionally, when Spanish banks regain primary markets access, only top-line issuers (namely BBVA and Santander) are able to tap the market.

Moreover, during that initial phase of market openness, the most common issued instruments are secured debt. This is the case not only because it is the main financial instrument used by banking institutions, but also because at this point the market only accepts high-quality debt instruments. As the market opens further, bonds are issued with longer maturities and lower spreads. Only after a transitional period of time, other credit institutions are able to place debt in the primary market.

New alternatives for bank funding

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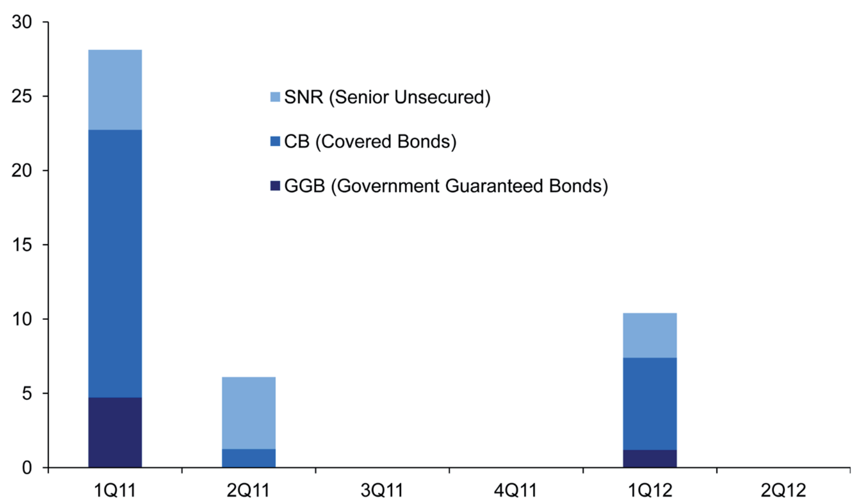
Exhibit 9

Issuance windows in the wholesale primary market for Spanish banks and cajas. Breakdown by term and collateral (€ bn)



Source: AFI from various sources

entities, banks and cajas, have not been able to issue debt in wholesale market since March 2012. Until March, secured instruments have been broadly used to tap markets, as shown in Exhibit 9.

The ECB has been crucial to avoid a liquidity crunch and to limit the cost of the commercial banks´ indebtedness. Thus, the Spanish banking system is not in a hurry to turn back to the wholesale market to raise funds at any price, which, if this occurred, could rapidly turn into a credit crunch.

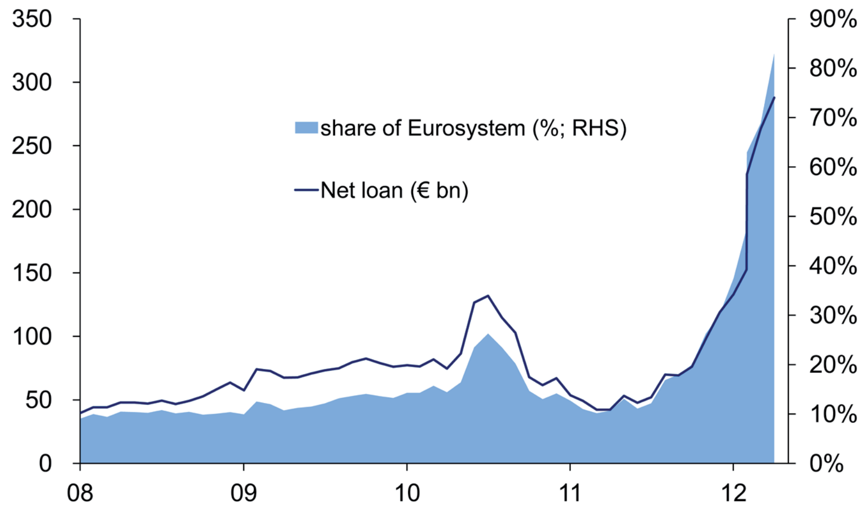
In this context, since credit institutions have not gained access to the funding markets and also they find it difficult to operate in the repo market (Clearing Houses such as LCH), reliance on the liquidity provided by the Eurosystem has become essential for Spanish credit institutions. In this sense, the ECB has been crucial to avoid a liquidity crunch and to limit the cost of the commercial banks´ indebtedness. Thus, the Spanish banking system is not in a hurry to turn back to the wholesale market to raise funds at any price, which, if this occurred, could rapidly turn into a credit crunch.

Due to restricted access to the primary wholesale market, it should not be a surprise that Eurosystem net loans to the Spanish banking sector reached 288 billion euros in May (last published data), which represents 83% of the overall amount of liquidity provided by the Eurosystem (347 billion euros).

Also, the extension of the ECB´s full allotment liquidity injections until, at least, December of 2012, will ensure the funding of the Spanish banking system in the short term. Nevertheless, the ECB measures are extraordinary by nature and are aimed to finish at some point in the near future. Thus, it is completely necessary for Spanish credit institutions to recover the confidence of the markets and come back to traditional funding channels through provision of

Exhibit 10

Spanish entities liquidity reliance on the Eurosystem



Source: AFI from Banco de España

credible solutions, at the European and national level, in order to reduce their heavy dependence on Eurosystem liquidity. These solutions should be in line with the measures included in the new draft of the Memorandum of Understanding on Financial Sector Policy Conditionality, published by the European Commission, such as: i) clarity on the recapitalization process, distinguishing correctly between banks with capital problems and those without, ii) credible restructuring or resolutions plans for the banks and cajas; and, iii) transparency measures in order to enhance risk identification and crisis management mechanisms, such as the creation of an external Asset Management Company to segregate legacy assets. In addition, it will also be necessary to design a roadmap for the Eurozone, which includes steps towards achieving a complete union: fiscal, financial, and political.