Outlook for the Spanish banking sector in 2013 and beyond: Completing the MoU and addressing remaining challenges

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Many requirements set by the July 2012 Memorandum of Understanding (MoU) for financial assistance to Spanish banks have already been carried out last year. Several important outstanding measures are expected by the end of June 2013, but challenges will remain over the next few years. Restoring financial stability, credit growth and reducing the cost for taxpayers will be the main factors in determining the success of the restructuring and recapitalization process in 2013 and beyond.

The implementation of the MoU requirements has shown significant progress since November 2012. Key steps such as the approval of the restructuring/resolution plans, the injection of the necessary capital for banks and the effective transfer of impaired assets from the banks to the asset management company Sareb, have been carried out. Importantly, these events have coincided with a relatively calmer situation in sovereign and private debt markets that has brought some stability to financial institutions. This can been seen in the increase in deposit inflows in November 2012, after observing a continuous outflow since March 2012. However, loans continued decreasing. Adoption of important pending measures, such as initiation of activities of the asset management company Sareb and the completion of new bank restructuring plans, should also be addressed in 2013. The completion of the efficiency plans of the banks in 2013 may help create a better environment for lending, but the growth of bank financing will ultimately depend upon the improvement of macroeconomic conditions.

Advances in the implementation of the Memorandum of Understanding (MoU)

The approval by the European Commission of the plans for the four banks[3] in which the Fund for the Orderly Restructuring of the Banking Sector (FROB) has a majority stake on November 28th, 2012, was a key milestone in the resolution of the banking crisis in Spain. These banks –classified as Group 1 according to the MoU criteria– were then set to receive the necessary equity funds to meet their capital requirements.

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The specific details of the plans have been unveiled and they will imply a significant reduction of the branch network and staff structure, as well as the shrinkage in activity through the sale of some assets, including participations in non-financial companies. Overall, this will imply a substantial deleveraging in the sector. The plans also include subordinated liability schemes (SLS), with haircuts on preference shares and subordinated debt, which seek to minimize the costs for taxpayers. Discounts for the holders of these debt instruments of Group 1 banks have ranged from 30% to 70%.

On December 26th, 2012, the Governing Committee of the FROB instrumented the recapitalization of these four banks with the injection of ESM funds for 36.97 billion euros. These institutions were thus set to meet the 9% minimum capital requirement identified in the stress tests that were released on September 28th, 2012. The recapitalization figures were lower than previous official estimations. The amount of impaired assets transferred to the Asset Management Company for Assets Arising from Bank Restructuring (Sareb) and the implementation of SLS –whereby preference shares and subordinated debt holders assume part of the losses– have explained the somehow lower amount of capital resources finally needed by these banks.

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Likewise, the recapitalization plans for the four banks under Group 2[4] requiring injections of capital were approved on December 20th. These banks received equity funds for 1.87 billion euros. Again, the transfer of assets of these banks to Sareb, the burden-sharing actions and the disposal of assets have reduced the official estimations of the capital needs of this group of banks.

The sum of the capital resources provided by the ESM and instrumented by the FROB to all Spanish banks amounts to 38.83 billion euros while the stress tests of Oliver Wyman estimated capital needs of 52.45 billion euros for these institutions.

As for the burden sharing exercise for Group 2 banks, the discounts on hybrid capital instruments affected by the SLS range from 25% to 70%. These banks will also develop substantial restructuring plans during 2013.

The establishment of Sareb was also a very relevant fact towards the end of 2012. On November 16th, the Bank of Spain issued a note on the Sareb "blueprint"[5]. In this note, it is mentioned that "the overarching objective of Sareb is to manage and divest in an orderly manner the portfolio of real estate loans and assets received from participating banks within a timeframe of no more than 15 years". The objectives of the asset management company include optimizing levels of recovery and value preservation; minimizing negative impacts on the Spanish economy, real estate market and banking sector; minimizing costs and the burden on taxpayers; fully repaying its liabilities and utilizing capital efficiently.

On December 13th, Sareb increased capital to allow private investors to take a stake in the management company. The Sareb provided a list of initial shareholders and their equity holdings. Five large Spanish banks provided equity for 430 million euros while the FROB had (as expected) a minor but still significant participation of 397

[4] Banco Mare Nostrum, Banco Caja 3, Liberbank and Ceiss.

[5] http://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/InformacionInteres/ReestructuracionSectorFinanciero/Archivo/Ficheros/en/background_frob161112e.pdf

million euros. The total equity funds provided were 827 million euros. As the targeted capital of Sareb was 3.8 billion euros, the Sareb approved a capital augmentation through subordinated debt that was also expected to be subscribed by private investors and the FROB. On December 17th, Sareb completed its equity shareholding with the entry of 14 new investors, including 2 foreign banks, 8 additional domestic banks and 4 insurance companies[6]. After that entry, the total equity funds provided by private investors amounted to 524 million euros and the contribution of FROB increased to 431 million euros. All the participating banks were also committed to subscribe subordinated debt issued by Sareb to increase the amount of own resources of Sareb to the expected 3.8 billion euros. This way, 25% of these sources will be equity capital and 75% will be subordinated debt.

The total amount of assets managed by Sareb will be around 50-53 billion euros as the assets transferred by the Group 1 banks will be 37 billion euros and the assets transferred by Group 2 banks are estimated to be around 13-16 billion euros.

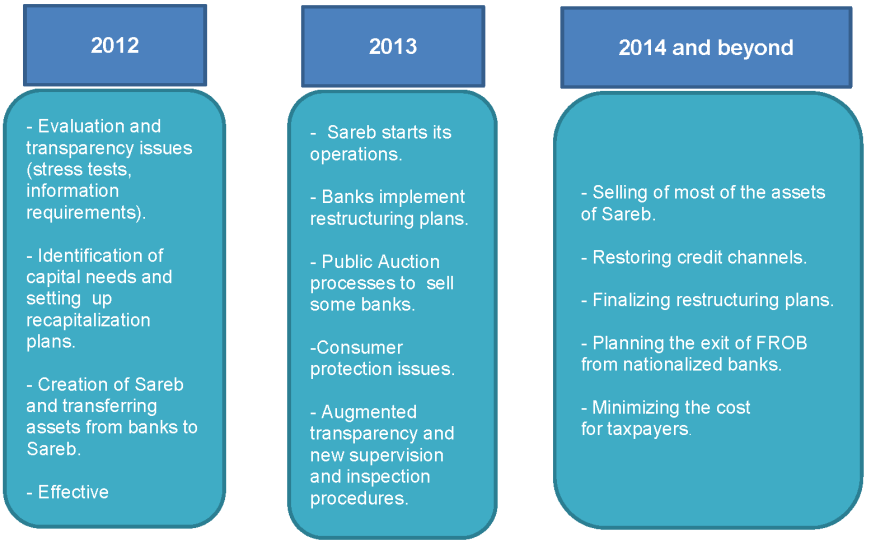
Importantly, the assets of Group 2 banks are expected to be transferred during the first quarter of 2013 and there is a possibility that such transfer could motivate a new equity capital increase and a new issuance of subordinated debt.

The MoU agenda for 2013

The MoU text includes 32 milestones to be completed over 2012 and 2013. As expected, 25 were undertaken in 2012. Importantly, this does not mean that these 25 measures are completely finished in practical terms as some of them consist of plans and/or institutional features that will have to evolve over the next few months/years. These features include, most notably, the operations of

Exhibit 1

The resolution of the banking crisis in Spain during 2012 and 2013, and beyond: A simplified perspective



Source: Authors' own elaboration.

[6] The Sareb shareholders are the following: Santander, Caixabank, Banco Sabadell, Banco Popular, Kutxabank, Ibercaja, Bankinter, Unicaja, Cajamar, Caja Laboral, Banca March, Cecabank, Banco Cooperativo Español, Deutsche Bank, Barclays Bank, Mapfre, Mutua Madrileña, Catalana Occidente and Axa.

Sareb, the restructuring plans of the banks and the exit of FROB from fully or partially nationalized banks. Exhibit 1 offers a simplified but illustrative way of looking at the achievements made and the remaining challenges.

As for the MoU requirements for 2013, some of them have been partially (or even fully) addressed in advance. The requirements and current status of the MoU are as follows:

a) Require all Spanish credit institutions to meet a Common Equity Tier 1 ratio of at least 9% by end-2014: the deadline for this requirement was January 2013 but it has been already fulfilled in advance with the completion of the recapitalization of banks in need of equity injections. This requirement also assumes that all Spanish banks will meet the definition of capital of the EU legislation that follows the European Banking Authority Standards.

b) Review governance arrangements of the FROB and ensure that active bankers will not be members of the Governing Bodies of FROB. This requirement has also been already fulfilled even if the deadline was January 2013.

c) Review the issues of credit concentration and related party transactions. This point was included in response to the identified problems of concentration of loans in the real estate sector as one of the main causes of the crisis in Spain. The way this problem is solved is one of the issues that the MoU text leaves more open. The Bank of Spain is covering some of these issues with new information and reporting requirements as well as with some new procedures in inspection and supervision that we will cover later on in this article. Therefore, this bullet point can be also considered as mostly fulfilled even if it was expected to be met by mid-January 2013.

d) 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: this was actually covered well in advance by the Spanish authorities with the Royal Decree-law 24/2012 released on August 31st, 2012. This decree set strict limits on the commercialization of hybrid capital instruments. These limits effectively result in the banning of such distribution among retail investors. The deadline for this requirement was February 2013.

e) Another issue is the amendment of the legislation of the credit register: the deadline was March 2013. The MoU explicitly mentions that "the Spanish authorities will take additional measures to improve the quantity and quality of information reported to the register". This amendment is being effectively carried out with the new information requirements mentioned above as well as with the distribution of supervision powers (including information requirements) enhanced by the RD-l 24/2012.

The final two requirements to be completed in 2013 refer to the possibility that some banks undergo a limited increase in equity or make use of CoCos to do so. The deadline for such actions is June 2013 but, as of now, it seems that this possibility will have a very limited impact on the recapitalization process. The requirements were defined as follows:

f) Raise the required capital for banks planning a more limited (less than 2% of RWA) increase in equity.

g) Group 3 banks with CoCos to present restructuring plans.

As noted above, one of the most relevant aspects related to the implementation of the MoU

at the beginning of 2013 has been the release of a report by an Internal Committee on the supervisory procedures of the Bank of Spain, with recommendations for their reform. As the MoU required, such report was elaborated during October 2012 although the main conclusions have been publicly revealed in January 2013. The report consists of a diagnosis of the supervision procedures of the Bank of Spain and suggests some improvements. These suggestions include the establishment of a standardized framework for the adaptation of supervisory measures based on the risk profile of credit institutions. A formalization of supervisory conduct is also expected. This will be mostly made by fostering the on-site supervision of financial institutions so that any prompt-corrective action can be implemented and monitored without delay. The revision of the supervision actions also embrace a strengthening of the planning procedures for inspections and the procedures for monitoring compliance with letters of requirements and observations.

As shown in Exhibit 1, even if the adoption of the MoU measures have been almost completed, the practical implementation of such measures and their final effects will be observed over the next few months and years. There are, at least, four issues that still represent a very important challenge for Spanish banks and the banking authorities:

a) The success in the operations of Sareb: this will be observed during 2013 and over the 15 years suggested time horizon. The performance of the Sareb will be decisive to determine the success of the resolution of the banking crisis in Spain. In the short-run, investors will closely look at the way the assets are sold and the extent to which the Sareb effectively contributes to the adjustment in house prices, which still needs completion. In the long-run, the main criterion to determine the accomplishment of Sareb will be the extent to which it minimizes the costs for taxpayers.

b) Restoring credit channels: this is ultimately the (long-run) goal of most of the regulatory initiatives aiming to solve the banking crisis. This is a very challenging issue in Spain given that macroeconomic conditions will still make it difficult for some time to observe an increase in loan supply. Recession is still causing an increase in the non-performing loans (NPL) ratio. In particular, in the mortgage portfolio where the efforts of banks and customers with renegotiations have maintained NPL in that segment at relatively low levels but the persistence of the recession may make these NPLs grow significantly in the next few quarters.

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c) Banks will have to implement demanding efficiency plans, which include the closing of branches and the reduction of personnel. Actually, we are effectively observing that such efficiency effort is not restricted to the banks that have submitted restructuring plans in accordance to the MoU but to most Spanish banks. There is corporate activity affecting a wide range of banks such as the absorption of Banesto by Santander.

d) As in other European countries, Spain will have to address the exit of the participation of public bodies (i.e. FROB) from the capital of banks. That means moving from nationalizations to privatizations.

e) Overall, a key objective will be to minimize the cost for taxpayers of the resolution of the banking crisis. As in other previous crises internationally, this will include both the fiscal (explicit) and quasi-fiscal (continent aid, guarantees) costs of resolution. These costs are only fully known in the long-run.

The status of financial intermediation in Spain

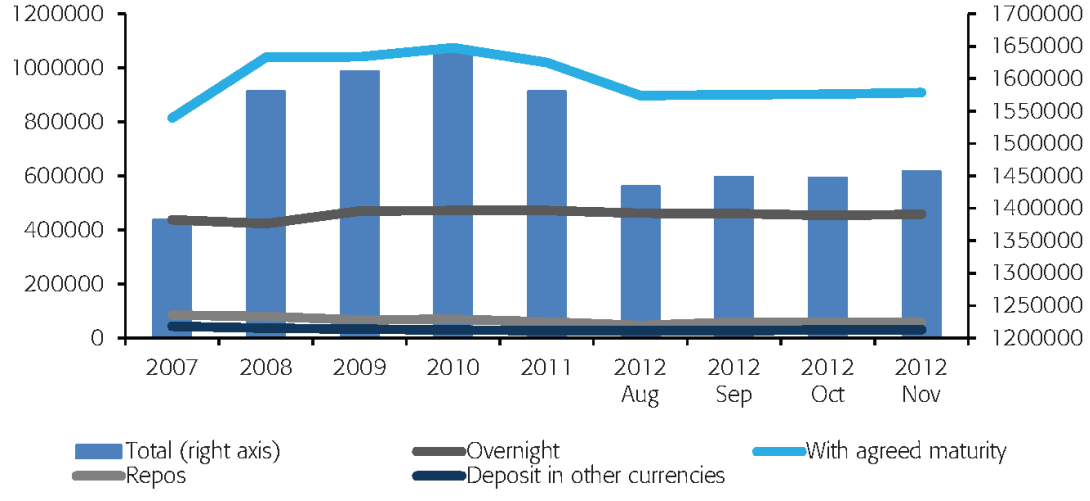
Considering the key restructuring and recapitalization plans that many banks are implementing in Spain in 2013, it seems a good time to analyze the situation of financial intermediation in Spain. To do so, we take advantage of some recent information published by the Bank of Spain on deposits and loans.

As shown in Exhibit 2, private sector deposits registered a monthly increase of 0.7% in November 2012, after a continuous fall from March 2012. Deposits from households and firms amounted 1.56 billion euros as of March 2012 and they decreased to 1.45 billion euros until October 2012. In November, they have grown to 1.46 billion euros. 62% of the deposits are termed deposits with agreed maturity (lower than two years for half of them) while 31% are overnight deposits. The increase in the deposits in November 2012 has been mainly driven by the savings accounts with agreed maturity of less than 2 years as many banks have been offering high rates (3%-4%) on such products.

As for loans, the evolution continues to be negative, as the annual growth rates of loans to firms and households fell by 4.6% and 3.6%, respectively in November 2012 being the largest fall –in particular for firms– of the period considered (see Exhibit 3). This evolution suggests that the credit restriction will still persist for some time. In this sense, the relatively better liquidity conditions observed at the beginning of 2013 may have a positive impact but cannot compensate the negative impact on lending from the current macroeconomic performance of the Spanish economy.

Exhibit 2

Private sector deposits in Spain (2007-Nov 2012)
(millions of euros)



Source: Bank of Spain and own elaboration.

Exhibit 3

Loan growth in Spain (2009-November 2012)

Source: Bank of Spain and own elaboration.

It will be very important for the Spanish banking sector to complete the restructuring plans through 2013, as this may help a number of banks to consider a way back to lending, in particular if the economy shows some signs of recovery towards the end of the year. It will have to be a relatively modest and selective flow of financing, in particular to SMEs which are in need of these funds and are solvent but face short-term funding problems.

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Table 1

Bank margins, provisions and profits of Spanish banks (2008- Sep 2012)

	Interest margin	Gross margin	Cost/income ratio	Total provisions/ total assets	Impairment losses/total assets	Return on assets
2008	1.16%	2.18%	46.5%	0.11%	0.50%	0.68%
2009	1.41%	2.21%	44.8%	0.04%	0.63%	0.49%
2010	1.12%	2.07%	48.5%	0.13%	0.54%	0.34%
2011	0.93%	1.80%	42.6%	0.06%	0.70%	-0.52%
sep-12	1.02%	1.90%	45.2%	0.15%	1.35%	-1.19%

Sources: Bank of Spain and own elaboration.

A look at some of the main indicators of bank performance as of September 2012 (Table 1) suggests that margins are becoming again a key strategic driver for Spanish banks. Both the interest and the gross margin increased in the third quarter of 2012. However, the need to set new provisions and to assume impairment losses led to negative year-on-year profits with a return on assets of -1.19%. These figures suggest that there is a positive franchise value in Spanish banks and the necessary cleanup is being made so that this value can finally emerge.

In 2013, it will be difficult for banks to increase lending and the credit restrictions are likely to continue but the completion of the recapitalization plans and of the restructuring process may represent important ingredients for lending recovery in a medium-term horizon if the prospects of an exit from economic recession are confirmed.