The Spanish banking system: Recent developments and prospects for 2014

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Recent assessments of the Spanish banking sector show that all the conditions established by the MoU are already in place. Also, the latest efforts at increased transparency are an ideal starting point ahead of the ECB´s comprehensive evaluation next year and reveal that the Spanish banking sector´s loss-absorption capacity and Common Equity Tier 1 (CET 1) capital ratio would be adequate to face even an adverse scenario.

In this article, we examine the most significant developments in restructuring, recapitalization, supervision and transparency of the Spanish banking sector from May to early November 2013. We begin by taking a look at the outcome of the last two external reviews conducted by the European Commission (EC), the International Monetary Fund (IMF) and the European Central Bank (ECB) on the status of implementation of agreed upon conditions under Spain´s Memorandum of Understanding with the European Union for financial assistance to the Spanish banking sector. It is important to note that while the reviews concluded that the programme remains on track, with implementation ahead of schedule, the importance of monitoring remains crucial, as many of the effects of the measures adopted can only fully be appreciated in the long-run. Additionally, we analyze some of the recent figures of the restructuring and recapitalization process. We then consider key issues regarding supervision, paying special attention to the improvement of certain supervisory and disciplinary powers at both the Bank of Spain and the Fund for the Orderly Restructuring of the Banking Sector (FROB). Finally, as regards asset quality disclosure, we provide some details on the first Forward-Looking Exercise on Spanish Banks (FLESB) and the methodology behind the comprehensive assessment of banks' balance sheets to be conducted by the ECB in November next year.

External reviews of Spain´s financial sector assistance programme

The third review of the financial sector assistance programme for Spain was conducted by the EC, the ECB and the IMF from May 21st to May 31st, 2013. At that time, implementation of the MoU measures, originally expected for July 2013, was close to completion. The EC and the ECB concluded that the programme remained on track. The Spanish financial markets had stabilized considerably during the first months of 2013 and the liquidity situation of the Spanish banking sector

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had also considerably improved. As the ECB and the EC noted, this allowed Spanish banks to further regain access to funding markets and to reduce reliance on central bank financing. One of the main achievements according to the analysis was the recapitalization of parts of the banking sector and the transfer of assets to the asset management company (SAREB). It was noted, however, that SAREB was still facing the big challenge of successfully managing and eventually divesting its portfolio of assets.

The EC and the ECB also considered as “nearly completed” the efforts (required by the MoU) to strengthen the governance, regulatory and supervisory framework of the Spanish banking sector. As we will discuss later on in this note, this has involved the reorganization and reinforcement of some supervisory and disciplinary powers of the Bank of Spain and FROB.

Even if the EC and the ECB acknowledged adequate fulfillment of the MoU conditions, they also highlighted some remaining challenges. In particular, and in line with previous external reviews, the deleveraging needs of the Spanish non-financial sector and the adjustment in the real estate market were considered as still far from complete and to “severely affect” lending volumes and, potentially, the asset quality of the Spanish banking sector. Thus, close monitoring of the system should continue in order to guarantee the final stabilization of credit institutions. Two main recommendations were issued. First, caution is required to help ensure that “the positive trends in the stabilization of the Spanish financial sector can be maintained”. Second, the burden sharing measures are to be completed and finalized.

The EC and the ECB also reiterated the importance of the ongoing assessments of the evolution of asset quality, solvency and resilience of Spanish banks that were being prepared by the Bank of Spain at that time and whose results we will cover later on in this note.

As for the IMF –in its role as independent monitor of the MoU– the Fund presented its full report on the third review in July and they also acknowledged that the “vast majority of measures specified in the MoU” were completed “under its frontloaded timetable.” The IMF mentioned as particularly relevant the actions aimed to recapitalize parts of the banking sector and the asset transfers to SAREB.

Importantly, as far as the recommendations for further improvement were concerned, the IMF divided the necessary improvements and efforts between the EU and the Spanish institutions. On the European side, further action included timely implementation of the Banking Union and maintenance of a sufficiently accommodative monetary stance. At the Spanish level, priorities included –in line with the EC and ECB recommendations– continued pro-active monitoring of financial sector health accompanied by strong supervision. The Fund particularly highlighted the Bank of Spain’s clarification of criteria for determining the classification of refinanced and restructured loans. The IMF called for a “rigorous application of these criteria” and to ensure adequate provisioning for loan losses.

A fourth review of the Financial Assistance Program to Spain was conducted by the EC and the ECB from September 16th to September 27th, 2013, with the main conclusions being released on September 30th. The continued improvement in financing conditions in Spain was again mentioned. Given the advances made by mid-2013, the EC and the ECB acknowledged that burden-sharing exercises with banks´ shareholders and junior bond holders were already virtually completed and that compliance with the “horizontal policy requirements” (the list of conditionality measures in the MoU) was nearly complete.

However, the external reviewers expressed their concerns that lending to the economy was still contracting substantially, “in particular against the backdrop of weak demand for new lending”. This was considered, to some extent, as a consequence

of the deleveraging process of the private sector. As a related recommendation, supervisors and policy makers were encouraged to "continue to monitor decisively the process of stabilizing the banking sector." Part of the reinforcement of such stabilization was to conduct an assessment of the shock resilience and solvency of the Spanish banking sector under the new transparency exercises announced by the Bank of Spain, whose results were released in early November (these results are discussed later on in this article).

Importantly, the EC and the ECB noted that another review was expected to take place in December 2013.

As for the IMF, their views after their fourth independent monitoring mission were very similar to those of the EC and the ECB. Again, there were no significant changes in the evaluation and recommendations compared to the third review. The IMF insisted once more on the importance of continuing with a proactive monitoring of financial sector health, given that the recovery of the economy was still considered to be at a very early stage. Again, they recommended a "thorough implementation of the ongoing review of banks' classification of refinanced loans" to ensure "adequate provisioning for loan losses." The IMF also welcomed the Bank of Spain's adoption of new guidelines recommending that banks limit cash dividends to no more than 25% of profits. They also considered as positive converting deferred tax assets arising from timing differences in provisioning rules into tax claims in order to reinforce solvency.

Progress made on the recapitalization process

Recent public information allows us to present the main facts and figures related to the recapitalization process and burden sharing exercises in the Spanish banking sector. The main recapitalization exercises imposed by the MoU have been described in previous editions of the *Spanish Economic and Financial Outlook*. In this note, we provide a brief summary of the quantitative impact of these changes along with the evolution of some of the main business indicators of Spanish banks in 2013.

First of all, the latest edition of the Bank of Spain´s *Financial Stability Report* from November 2013, offers some interesting insights on the recent evolution of the banking business. In particular, financing to the private sector, including credit and fixed income, has decreased its relative weight in banks' balance sheets to 60.6% in June 2013 (61.5% in the previous year). Financing to the private sector fell as a consequence of the year-on-year reduction in credit to the private sector. In particular, it fell by 11% in June 2013. The weight of financing to the private sector in banks' balance sheets decreased from 58.8% in June 2012 to 56.1% in June 2013. This reduction is due, to a large extent, to a one-off change in the composition of banks' assets after the transfer of assets of Group 1 and 2 banks –according to MoU definitions– to SAREB. It is important to note that Group 1 and 2 banks account for 6.3 percentage points of the 11% aggregate fall in credit for the sector as a whole as of June 2013. Some recent updates of these figures show that the year-on-year rate of change of credit to the private sector in Spain was -12.8% as of August 2013. All these figures suggest that the credit crunch is still intense in Spain.

Even if economic growth figures have shown some improvement in the last few months, unemployment is still having a significant negative impact on the quality of outstanding loan portfolios. Specifically, total doubtful assets increased by 5.1% year-on-year in June 2013. In any event, the deterioration path has slowed compared to June 2012 (18.9%).

As for profitability, Spanish banks' income increased by 8.24 billion euros between January and June 2013, which represents a significant improvement from the losses of 3 billion euros

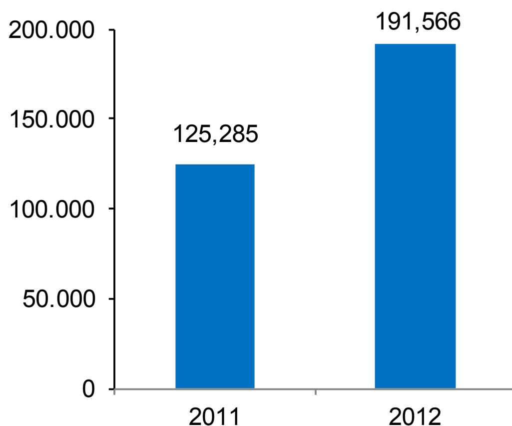
registered in the same period in 2012. The return on assets (ROA) as of June 2013 was 0.45% compared to -0.17% in June 2012. The return on equity (ROE) was 7.8% in June 2013 (-3% in June 2012).

There have also been improvements in the solvency position of the banks. In particular, the tier 1 ratio for the entire sector was 10.8% in June 2013, while it was 9.7% in June 2012. As noted in the *Financial Stability Report*, there has been a composition change regarding own funds, as higher quality capital is reducing the weight of other forms of capital. Taking a longer time horizon, it is worthwhile to note that the weight of tier 1 capital as a percentage of total own funds was 72% in June 2008 and has increased to 94% in June 2013. Tier 2 capital has declined as a consequence of the reduction in subordinated debt, which fell by 43.2% in June 2013 as compared to June 2012.

Exhibit 1

Provisions and reserves applied to cover impairment losses

(million euros)



Source: Ministry of Economic Affairs and own elaboration.

As seen in Exhibit 1, the evolution of bank profits and solvency has been largely affected by the resolution tools put into action in the last years. According to the data provided by The Ministry of Economic Affairs, the considerable effort made by financial institutions in terms of provisions and reserves applied to cover impairment losses amounted to 191 billion euros by the end of 2012.

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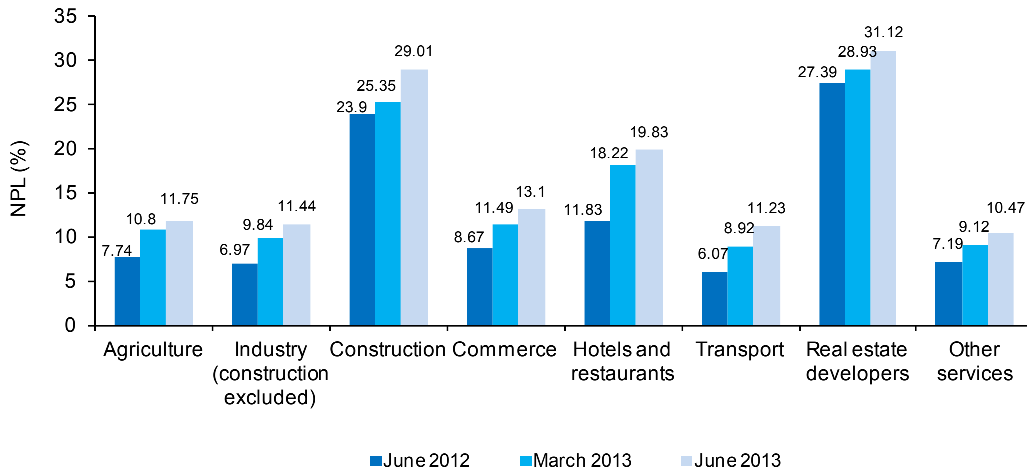
In any event, it should also be taken into account that there are some remaining downside risks given macroeconomic conditions. The potential impact of these risks are discussed later on in this note but, as shown in Exhibit 2, non-performing loans are increasing and are becoming increasingly more and more relevant in sectors not related to construction or real estate.

Another important milestone in addressing impairment losses resulting from the recent transparency measures imposed by the Bank of Spain is also shown in the latest *Financial Stability Report*. In particular, as of September 2013 and after the new reclassification rules of the Bank of Spain are applied, Spanish banks will have increased the amount of refinanced and restructured loans considered to be doubtful by 29% to 92.224 billion euros (see Exhibit 3). After a review of the quality of their refinanced loans, the country's banks categorized only 48.19 billion euros as standard loans, compared with 73.55 billion euros before the new criteria were applied. The amount of sub-standard loans was increased to 40.88 billion euros from 37.21 billion euros.

Exhibit 2

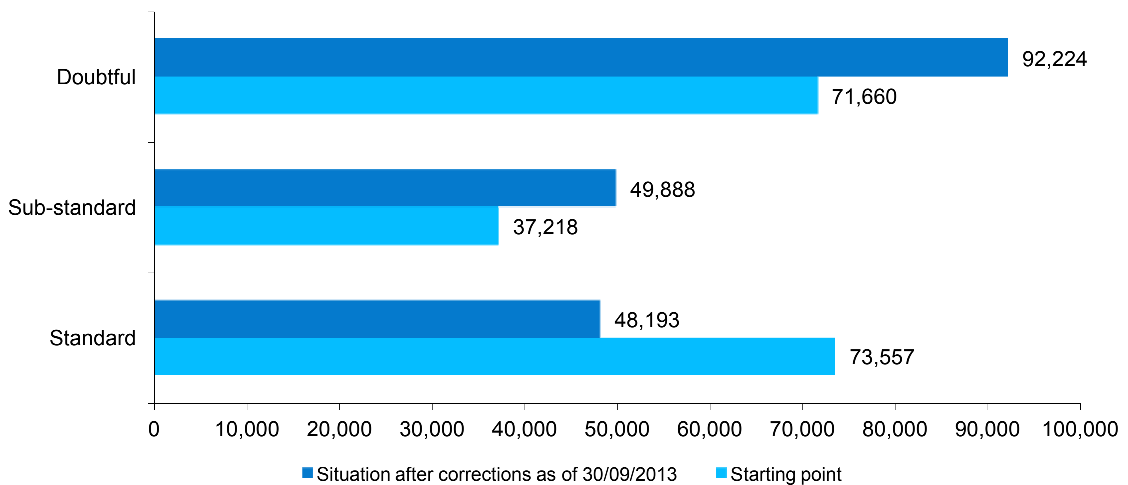
Non-performing loan ratio by sector



Source: Bank of Spain and own elaboration.

Exhibit 3

Effects of the application of the new Bank of Spain loan classification rules (millions euros)



Source: Bank of Spain and own elaboration.

Latest burden sharing exercises

Together with the improved solvency conditions and the progressive recovery of bank profits –even if there are still the abovementioned downside risks– another relevant feature in the period analyzed in this note has been the development of some burden sharing exercises. In particular, those that referred to two of the nationalized lenders, Catalunya Banc (CX) and NCG Banco (NCG). On June 7th, 2013, the FROB approved the hybrid capital and subordinated debt instrument management (burden-sharing) exercises envisaged in the resolution plans for CX and NCG. As for preference shares and perpetual subordinated debt, they were expected to be converted into shares applying a haircut to their face value. As for dated subordinated debt, a choice was permitted between shares or senior debt with the same maturity as the subordinated debt, and also different haircuts on the original face value were applied.

In accordance with the FROB calculations, these transaction also involved an illiquidity discount of 13.8% of the economic value of the shares.

Decision making tools and supervision and resolution powers for the Bank of Spain and the FROB

As previously stated, one of the latest recommendations of the MoU referred to the improvement in the decision-making and resolution powers of the Spanish supervisors. A major step in this direction was taken by the Bank of Spain in late September 2013, when the Executive Commission of the Bank of Spain approved an internal Circular of Procedures applied in the Directorate of General Banking Supervision (Internal Circular 2/2013), updating the rules that were in force at that time (Internal Circular 7/2011).

The new Circular includes a number of mandatory procedures that were supposed to be undertaken by early 2014. In any event, the Bank of Spain acknowledged that the new procedures will very probably have to be updated once the Single Supervisory Mechanism (SSM) within the European Banking Union is in place in late 2014. The most relevant changes in the approved Internal Circular were the following:

- Formal documentation of on-site continuous monitoring and remote monitoring is improved. In particular, on-site and remote monitoring are to be formally documented in a periodic report, similar to the inspection report. The intention of the Bank of Spain here is that supervisory procedures "result in letters of recommendation to or requirements for institutions, even if the institution has redressed the shortcomings detected by the inspection team."

- Greater speed of supervisory procedures. Banks will be encouraged to correct the shortcomings detected by inspection teams at a faster speed than in the past. This means that once the on-site work has been completed, a summary letter of the situations observed is sent to the bank with the eventual recommendations and requirements made by the Executive Commission.

- Greater detail in regulating the procedure of verification of compliance with requirements letters. A specific period of six-months was set as a deadline for the duration of extraordinary supervisory procedures, and within this period a specific report will be produced on the outcome of the inspection procedures.

- Simplification of tasks and improved resource allocation. A simplified system of remote monitoring is established, based on quarterly warnings highlighting potential problems detected in the confidential reports and the information submitted by the banks to the Central Credit Registry. The aim is to detect "potential future problems of liquidity, solvency and profitability."

- Formal documentation of discrepancies in the opinion-forming process. The discrepancies, if any, that might arise in the process of forming an opinion on the institution's situation (already envisaged in Circular 7/2011) will be detailed in a specific section of the report to the Executive Commission. To date, when these discrepancies arise, they are included in a separate report attached to the rest of the supervisory documentation.

- "Nature" of the inspection reports and the monitoring notes. These reports are required to bear two signatures, that of the individual responsible for the report and that of the Head of Division.

Also following the principles of the MoU – the FROB approved a "general framework for action to supplement its decision-making powers in relation to possible corporate operations". This general framework was announced in October 2013. This new framework is set to facilitate the success of corporate operations "to resolve credit institutions." The principles approved by FROB are mainly the following:

- The main aim is to avoid problems of "fairness for the creditors or shareholders" of a bank resulting from the general rules applied.

- A clear economic justification should be provided –and validated by an independent expert– to demonstrate the preservation of value for the FROB and the minimization of costs for taxpayers.

- The principles set by the FROB should comply with the European rules on State aid.

First forward-looking exercise by the Bank of Spain

A key step in increasing transparency was taken by the Bank of Spain in November 2013 with the publication –in the *Financial Stability Report*– of its own forward-looking analysis of Spanish banks. The Bank of Spain published the methodology and initial results of this exercise, which is expected to be undertaken regularly in the future.[3]

A key step in increasing transparency was taken by the Bank of Spain in November 2013 with the publication of its own forward-looking analysis of Spanish banks, the FLESB, which is expected to be undertaken regularly in the future. The aim of the FLESB is to evaluate the solvency of banks in the face of different scenarios over a specific time horizon.

The Bank of Spain considers that this methodology implies the adoption of "best international (US and UK) practices in the area, incorporating forward-looking analyses to its range of supervisory tools." One of the key issues of the analysis is that it is built from "granular" elements (that is, a bottom-up approach) at the level of individual loans with the information obtained from the Central Credit Registry. The analysis is called FLESB (Forward-Looking Exercise on Spanish Banks). The aim of the FLESB is to evaluate the solvency of banks in the face of different scenarios over a specific time horizon.

The first analysis published by the Bank of Spain takes December 2012 as the starting point and spans a three-year period from 2013 to 2015. The main target of the analysis is the resident private sector's credit portfolio and the related foreclosed assets. The credit portfolio is classified into six categories, including real estate developers, construction, corporate, SMEs, retail mortgage lending and consumer loans. As the analysis points out, "It has been borne in mind that in December 2012 and in February 2013 the Group 1

[3] The full text of the *Financial Stability Report* can be downloaded from the following link: http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinancera/13/IEF_Ing_Noviembre2013.pdf

and 2 institutions, respectively, transferred assets to SAREB, with these assets and the provisions set aside for them therefore being excluded from the scope of the analysis."

The FLESB sets a benchmark capital ratio as the Common Equity Tier 1 (CET1) defined in the CRR/CRD IV. This means a minimum regulatory capital (in terms of CET1) of 4% in 2014, and 4.5% in 2015.

There are three macroeconomic scenarios considered. In the baseline scenario, the economy experiences "a modest recovery." In this scenario, the Spanish economy leaves the recession, although with modest GDP growth rates, as in most of the current estimations. The second scenario, is called the "unfavorable scenario" whereby the Spanish economy "would scarcely grow in the period considered." In particular, the cumulative output growth from 2013 to 2015 would be 1.7% lower than in the baseline scenario. As the technical note mentions, this gap between cumulative GDP growth in the two scenarios matches that implicit in the forecasts of the IMF's October 2013 *World Economic Outlook*. The third macroeconomic scenario is the so-called "adverse scenario," and would entail "a fresh dip in the Spanish economy." In this scenario the accumulated gap from GDP growth in the baseline scenario is 3.2%.

As for the main results of the FLESB, in the baseline scenario, the expected losses are 7.6% of total credit. This percentage increases to 8.8% in the unfavorable scenario and to 9.7% in the adverse scenario. If the expected losses associated with foreclosures are added, the percentages of total expected losses (losses on the credit portfolio plus those of the foreclosures over credit exposures plus foreclosures) increase in each one of the scenarios. As are shown in Exhibit 4 the total expected accumulated losses from the credit portfolio in the adverse scenario would amount to 122 billion euros and those from foreclosed assets would be 38.9 billion euros.

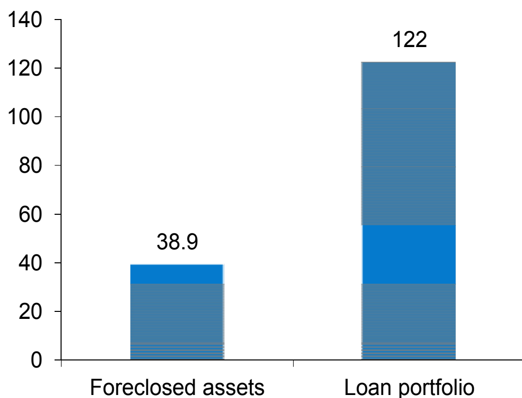
As shown also in Exhibit 4, there is a significant estimated loss-absorption capacity that would

Exhibit 4

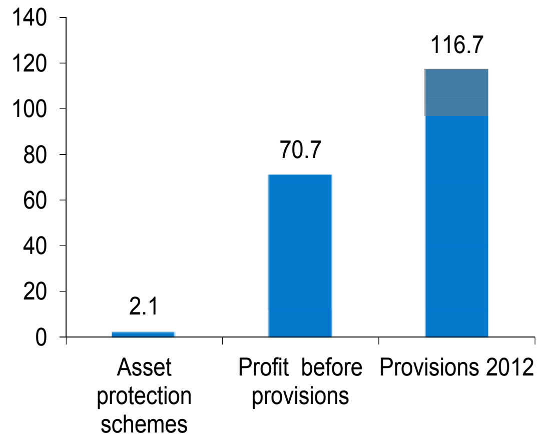
Main results of the forward-looking analysis of the Spanish banking sector conducted by the Bank of Spain

(billion euros)

Expected losses 2013-2015



Loss absorption elements



Source: Bank of Spain and own elaboration.

eventually be enough to cover potential losses, even in the most adverse scenario. The overall estimation of the Bank of Spain is that there is "a fairly comfortable solvency position at the aggregate level in 2015." In particular, in the adverse scenario, the loss-absorption capacity would exceed expected losses by 28.6 billion euros and the CET1 capital ratio would be 11.3% in the baseline scenario, 10.8% in the unfavorable scenario and 10.2% in the adverse scenario in 2015.

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Comprehensive assessment by the European Central Bank

The forward-looking analysis of the Bank of Spain can be seen as a key step for increased transparency. Importantly, it is also a useful tool ahead of the comprehensive assessment of banks' balance sheets that the ECB is expected to undertake in November 2014. Some general methodological aspects of this ECB analysis were published in October 2013[4] and are discussed in this note.

The ECB exercise will involve 130 banks from 18 Member States. This represents approximately 85% of the bank assets in the Eurozone. This is a first and important issue of this analysis as the previous tests that were conducted by the European Banking Authority (EBA) had much more limited coverage.

As was the case for Spain in 2012, Oliver Wyman has been chosen as the consultancy group that will give independent advice to the ECB on the methodology. The assessment will comprise three "complementary pillars."

- A supervisory risk assessment: this will address the key risks in the banks' balance sheets, including liquidity, leverage and funding risk.
- An asset quality review: this will examine the asset side of banks´ balance sheets. The ECB specifically notes that the "assessment will be broad and inclusive, comprising credit and market exposures (including a quantitative and qualitative review of hard-to-value assets), on and off-balance sheet positions and domestic and non-domestic exposures."
- A stress test, building on and complementing the asset quality review by providing a forward-looking view of banks' shock-absorption capacity under stress scenarios.

The capital benchmark for the exercise will be set at 8% Common Equity Tier 1. The threshold can be decomposed into a Common Equity Tier 1 ratio of 4.5%, and in addition, the 2.5% capital conservation buffer. An add-on of 1% will also be requested. This total Common Equity Tier 1 ratio of 8% will constitute the minimum capital requirement for all of the banks covered by the comprehensive assessment. It is calculated as a ratio to risk-weighted assets, derived from the asset quality review.

Although more details will be needed to estimate the expected effects of this evaluation, there are some good news from the Spanish perspective

[4] The technical note can be downloaded here: http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf?6d565e82ff67a0d842085c2b6889f010

for at least two reasons. First of all, Spanish banks have already gone through various comprehensive assessments and increased transparency exercises since 2012 following the MoU principles. Secondly, Oliver Wyman already conducted a similar exercise for Spain and the necessary recapitalization measures have already been put in place.