Foreign banks' exposure to Spain: The return of investor confidence

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Recent data point to improved confidence in the Spanish economy and financial sector. In particular, increased direct exposure to Spain by foreign banks from mid-2012 to mid-2013 relative to the previous 12 month period is proof that the country has gone from a situation of capital flight to one in which foreign investor confidence in the Spanish economy is returning.

The episode of capital flight observed in Spain in the wake of the sovereign debt crisis seems to be coming to an end as investors return to the Spanish market. Global banking system exposure to both Spanish public and bank debt appears to have recovered in the twelve months subsequent to the ECB´s pledge to support the euro in mid-2012. The improvement in the outlook for the public debt has translated into a reduction in Spain´s risk premium. Corporate debt exposure, however, continues to decline as a logical consequence of the necessary deleveraging process. While these developments give cause for cautious optimism, foreign banks on the whole have still reduced their exposure to Spain in cumulative terms since the summer of 2011. Moreover, to reduce borrowing rates in a meaningful way, further improvement in investor confidence and rapid progress on banking union are needed.

The Spanish economy has passed a turning point in recent months, allowing it to emerge from the recession in which it had been mired for several years. There is a variety of evidence to support that this change has occurred. For instance: GDP rose in the third and fourth quarters of 2013 after nine consecutive months of contraction; the unemployment rate fell; the current account recorded a surplus after several years of deficit; external debt is down from mid-2013 levels; and the risk premium has fallen to well below its peak in mid-2012.

Alongside these indicators there is one that clearly shows that confidence in the Spanish economy has improved in recent months - the recovery in foreign investment in Spain, in terms of both foreign direct investment and portfolio investment. Thus, compared with a capital flight of 158 billion euros in financial assets between 2010 and 2012, between January and October of 2013, external portfolio investment in Spain was -6.8 billion euros. While remaining negative, this represents a dramatic shift in confidence in Spain. In the case of direct investment, in 2013 the figure to October had risen by 56% on the same month in 2012.

This improvement in confidence in the country's economy can be expected to extend to the banking sector, now that the economy is emerging from

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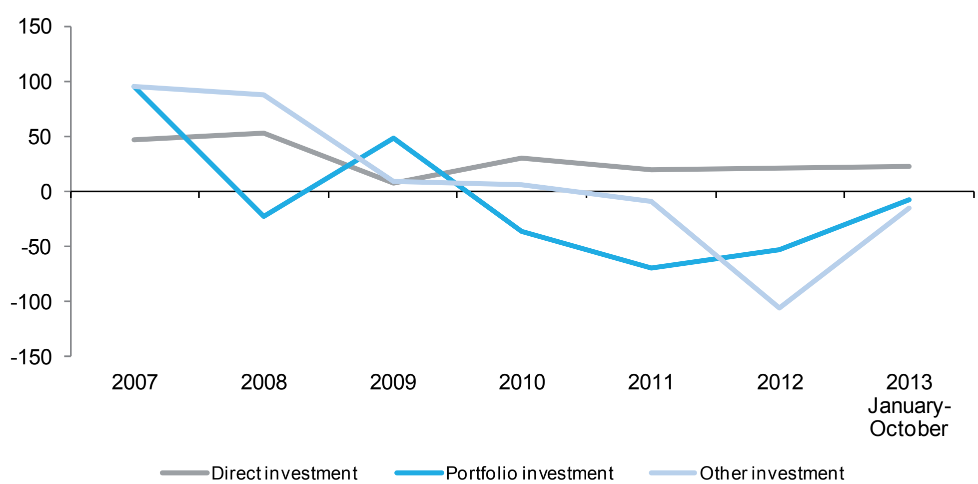
recession and the financial assistance programme is drawing to a close, against the backdrop of the major restructuring and balance sheet clean-up undertaken. Indeed, as indicated by both the IMF and the European Central Bank/European Commission in their report on the fifth and final review of the financial assistance programme for Spain in December 2013, “Spanish banks are gradually regaining access to financial markets,” which is of itself an indicator of investors’ improved confidence in the Spanish banking sector. In addition, several Spanish banks recently placed capital with foreign investors and one of the bailed-out institutions managed by the FROB has been sold to a foreign bank. Moreover, in the first days of 2014, even two of the nationalized banks have been able to issue bonds at lower than expected prices.

In this context, this article aims to use Bank for International Settlements (BIS) information to analyse recent changes in the world’s main banking sectors’ exposure to Spain. The BIS has produced quarterly information on third-country debt holdings on bank balance sheets since 2010, allowing banks’ exposure to foreign debt to be analysed country by country. It is of particular interest to examine whether the improvement in confidence in the Spanish economy as shown by the data on foreign investment in Spain also shows up in third-country banks’ holdings of Spanish debt (issued by companies, banks or the public sector). To do so, the change in foreign banks’ exposure to Spain from June 2011 to June 2012 in the wake of the sovereign-debt crisis has been analysed and quantified, and compared with the subsequent period from June 2012 to June 2013. The conclusion drawn from these two sub-periods is that Spain has gone from a situation of capital flight to one in which foreign banks’ confidence in the Spanish economy is returning.

Recent trends in foreign investment in Spain

After the outbreak of the crisis in mid-2007 foreign portfolio investment in Spain fell sharply. As Exhibit 1 shows, in 2008 alone, the situation switched from one in which foreign investors held

Exhibit 1
Foreign investment in Spain
Billions of euros



Source: Bank of Spain.

almost 100 billion euros in investments in Spain to a net negative investment position of 22 billion euros, with the consequent capital flight. Foreign portfolio investment recovered in 2009, but only briefly, as the net divestment between 2010 and 2012 was 159 billion euros, equivalent to more than 15% of GDP.

In the case of direct investment, levels since 2009 have hovered around 20 billion euros, slightly less than half their pre-crisis level. It is in 2013 that the trend change became perceptible, with investment from January to October 2013 (23.4 billion euros) 56% up on the same period of 2012 (15 billion euros).

As well as portfolio and direct investment, there is a third type of investment that mainly comprises deposits, loans and repos. The situation for this type of investment also improved in 2013. Thus, from foreign investment in Spain (excluding the Bank of Spain, whose investment basically comprises the banks' recourse to Eurosystem financing) between January and October 2012 of -119.7 billion euros, the figure has improved to -15.2 billion euros in the same period of 2013.

Foreign banks' investments in Spain

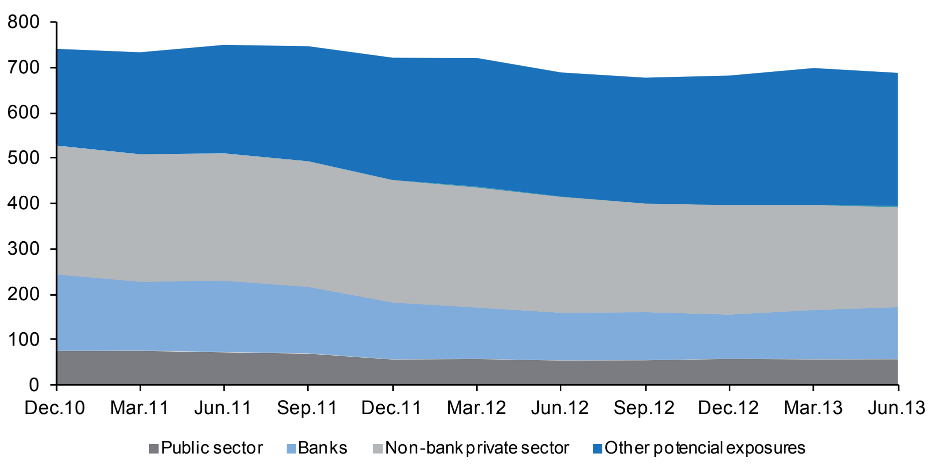
The BIS database on "consolidated foreign claims and other potential exposures-ultimate risk basis" gives information from 2010 to June 2013 (most recent data available) on the exposure of banks in 24 countries (the world's leading economies) to debt issued by third countries. This makes it possible to analyse what banking sectors hold the debt issued by a specific country and what countries a particular banking sector invests in. The BIS data includes direct exposures (foreign claims), with data broken down into debt issued by the public sector, banks, and non-financial corporations, and indirect exposures (other potential claims): derivatives, guarantees and other commitments.

Exhibit 2 shows how the global banking system's exposure to the Spanish economy has changed.[2]

Exhibit 2

Foreign banks' exposure to Spain

Billions of euros



Source: BIS and author's calculations.

[2] The BIS data is denominated in dollars. The monthly exchange rate at the end of the period has been used to convert it to euros.

In the case of direct exposure in the form of the purchase of debt instruments, current values are 25% lower than in 2010, with a drop in absolute terms of 132 billion euros, such that the total Spanish debt held by foreign banks in June 2013 came to 397 billion euros. The decline in the global banking system's exposure to Spain began in 2011 with the outbreak of the sovereign-debt crisis following Greece's first bail-out. Thus, in June 2011 exposure to Spain had dropped by 18%, with a 95 billion euro reduction in the debt –equivalent to almost 10% of GDP– in just a year.

There was a clear turning point in mid-2012, as Europe's financial stability improved after the president of the ECB famously pledged to "do whatever it takes" to save the euro. Thus, between June 2012 and June 2013 the global banking system's exposure to Spain fell by 5% or 20 billion euros, less than a sixth of the drop a year earlier.

The breakdown by debt type shows the steepest drop in exposure to Spain since the start of the sovereign-debt crisis to be in the case of bank debt, as foreign banks' holdings of bank debt fell by 28%. This drop continued until mid-2012. Since then, it has recovered, with an increase of 9.4% (9.7 billion euros).

The world's banks also reduced their holdings of Spanish public debt, with a drop of 25% between June 2011 and June 2012, and a recovery of 5% in 2013. Foreign banks' appetite for Spanish public debt began to return in the summer of 2012, in line with the figures from the Treasury on holdings of Spanish public debt by non-residents, which increased by 25% between August 2012 and June 2013, and have increased by 31% since October 2013. Again, the turning point came in the summer of 2012 with the ECB's firm commitment to the euro.

The global banking system's exposure to Spanish corporate debt has continued to decline steadily since mid-2011, with the contraction accelerating over the last twelve months. This process is logical considering Spanish businesses' high level of debt and the necessary deleveraging underway. The debt issued by Spanish businesses held by foreign banks therefore dropped by 60 billion euros between June 2011 and June 2013.

In the case of indirect exposures to Spain, current levels are 22% higher than before the sovereign debt crisis broke out. This is due to the increase in guarantees, the value of which has grown by slightly more than 50%, to reach 227 billion euros today. These figures put foreign banks' total exposure to Spain at 687 billion euros, 8% less than in June 2011.

Disaggregation by countries

Which banking sectors have the biggest exposures to debt issued by the Spanish economy? To help answer this question, Exhibit 3 shows the ranking of Spain's creditor countries ranked from greatest to least exposure. In terms of total exposure (foreign claims and other potential exposures), US banks have the biggest exposure to Spain, at 196 billion euros, equal to 28.6% of the total. The United States is followed in magnitude by the United Kingdom (120 billion euros), Germany (119.5 billion euros) and France (103 billion euros), with shares of 17.5%, 17.4% and 15%, respectively. These four banking sectors consequently account for 90% of the Spanish economy's foreign debt held by foreign banks.

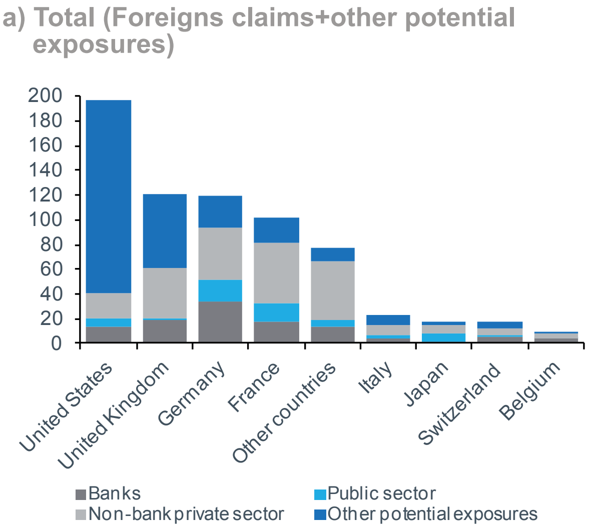
US banks' high exposure is mainly explained by the guarantees it has vis-à-vis Spanish debt, with other potential exposure representing 90% of its total exposure to Spain.

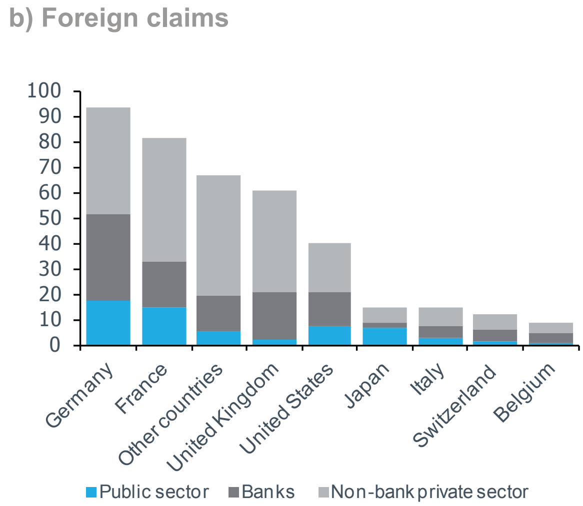
Focusing on direct exposure in the form of debt purchases, panel b of Exhibit 3 shows German banks to be the most exposed to Spain (23.5% of the total), with a debt of 93 billion euros. Banks in France, the United Kingdom and the United States follow Germany's banks in terms of their exposure

Exhibit 3

Foreign banks' exposures to Spain. June 2013

Billions of euros





Source: BIS and author's calculations.

to Spain, with totals of 82 (20.8%), 61 (15.4%) and 40 (10.1%) billion euros, respectively. These four countries account for 70% of the Spanish economy's foreign debt held by foreign banks.

Looking at the data by debt type, German banks held the bulk of foreign banks' 58.4 billion euros of Spanish public debt, with 17.5 billion euros, or 30% of the total, on their balance sheets. French banks have the second largest exposure (15%), holding 15 billion euros of Spanish public debt. US and Japanese banks are further behind (with 7.5 billion euros and 6.6 billion euros, respectively), and the exposure of Italian banks (2.8 billion euros) and UK banks (2 billion euros) to the Spanish public sector is relatively small.

In terms of direct exposure in the form of debt purchases, German banks are the most exposed to Spain (23.5% of the total), with a debt of 93 billion euros. Banks in France, the United Kingdom and the United States follow Germany's banks in terms of their exposure to Spain, with totals of 82 (20.8%), 61 (15.4%) and 40 (10.1%) billion euros, respectively. These four countries account for 70% of the Spanish economy's foreign debt held by foreign banks.

In the case of foreign banks' holdings of debt issued by Spanish banks, of the total of 113 billion euros, 30% has been bought by German banks (34 billion euros), twice the amount held by British and French banks, and almost three times that held by US banks. Finally, foreign banks have 221 billion euros of debt issued by Spanish businesses on their balance sheets, with French, German and British banks being the main creditors, holding 60% of the total.

Have foreign banks' perceptions of Spain improved?

As noted, the increase in foreign direct and portfolio investment in Spain shows that investors' perception of the Spanish economy has improved in recent months. Europe's more stable financial climate since mid-2012 is primarily due to the ECB's response and its commitment to the euro, which ushered in a new era of falling risk premiums.

In the specific case of foreign banks' perceptions, the BIS data also confirms a recovery in confidence in Spain, in complete contrast to the situation a year earlier following the outbreak of the sovereign debt crisis. As Exhibit 4 and the detailed information in Table 1 show, whereas from June 2011 to June 2012 foreign banks reduced their holdings of Spanish debt by 94.5 billion euros (18%), between June 2012 and June 2013 the drop was 20.2 billion euros (5%), i.e. almost a fifth smaller. The drop in the wake of the sovereign-debt crisis affected all types of debt, although the biggest fall was in bank debt, which dropped 34% in just a year, obliging Spanish banks to draw heavily on ECB funding. There was also a sharp decline in foreign banks' public debt holdings, which fell by 25% (18.1 billion euros) in just a year.

The fact that foreign banks have regained their confidence in the Spanish economy since the summer of 2012 is shown by their increased holdings of public debt, and to a larger extent, bank debt, which have risen by 5% and 9%, respectively.

The fact that foreign banks have regained their confidence in the Spanish economy since the summer of 2012 is shown by their increased holdings of public debt, and to a larger extent, bank debt, which have risen by 5% (2.7 billion euros) and 9% (9.7 billion euros), respectively. By contrast, holdings of private non-financial sector debt has fallen sharply (14% or 35.4 billion euros). However, rather than a loss of foreign banks' confidence in Spain, this should be interpreted as part of the essential deleveraging underway by Spanish businesses. The consequent contraction in foreign banks' Spanish corporate debt holdings is therefore to be expected.

The exposure of foreign banks to Spanish debt under the "other potential exposures" heading continued to rise between June 2012 and June 2013, although much less so than during the preceding year. This increase is explained by the guarantees extended, while the exposure from derivative contracts has reduced.

The disaggregated data reveals significant differences between countries in the way their exposures to Spain have changed. Thus in the case of debt holdings (foreign claims), in some countries, such as Belgium, Switzerland, and above all, the United States, the situation has gone from capital flight as the sovereign-debt crisis broke out, to a recovery of investors' confidence. In the case of the US, after a reduction in exposure to Spain of 23% (10 billion euros), between June 2012 and June 2013, debt holdings have risen by 18% (6 billion euros), which is a clear sign of renewed confidence in Spain. Even in a scenario of businesses deleveraging, US banks' exposure to Spain has increased in the case of non-financial public debt, although the strongest growth was in exposure to public debt, which rose by 56% (2.7 billion euros).

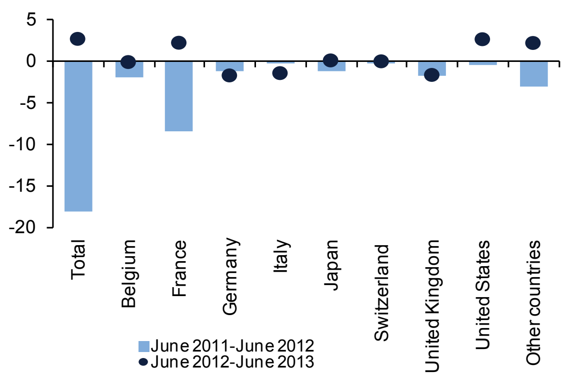
Among European banks, the strongest recovery of confidence has been in Germany and the United Kingdom, although overall, total Spanish debt held by these countries' banks has continued to decline. Germany has gone from a position in which its banks reduced their exposure to Spain by 20.7% to one in which the reduction is 4.2%. And in the United Kingdom the reduction has narrowed from 11.6% to 1.3%. Nevertheless, these figures should be interpreted with caution as they include the private debt of the non-financial sector, which is in the midst of a deleveraging process. Thus, excluding non-financial corporate debt, exposures to Spain have risen in France, Germany, the United Kingdom and the United States since June 2012.

Exhibit 4

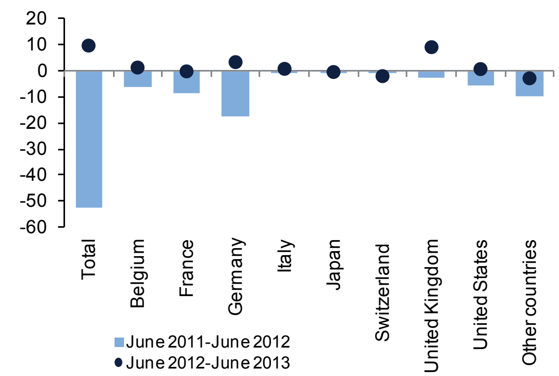
Variation in foreign banks' exposure to Spain

Billions of euros

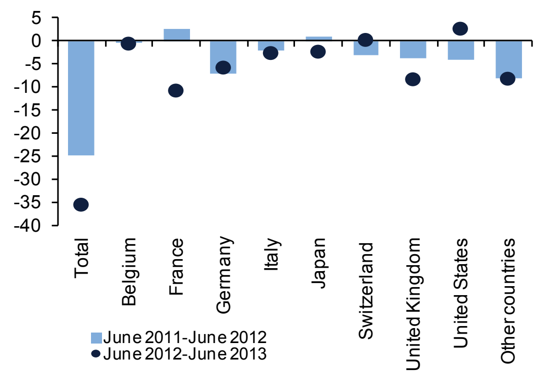
a) Public sector



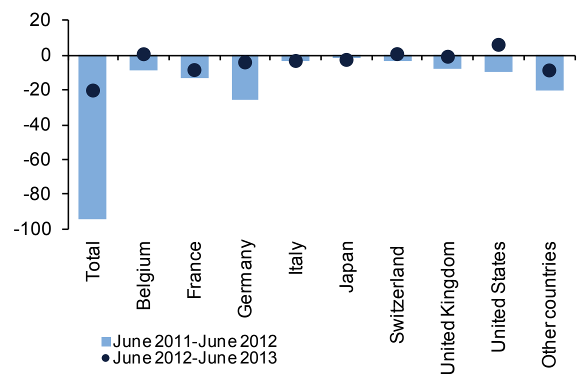
b) Banks



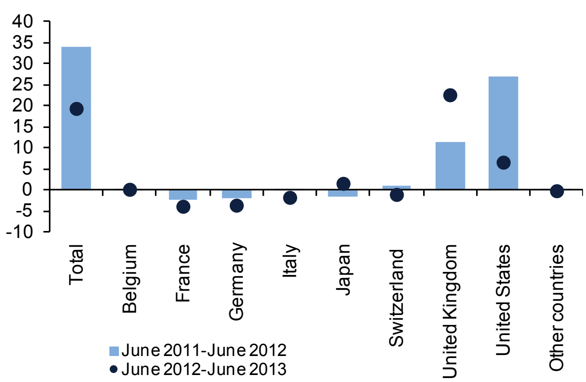
c) Non-bank private sector



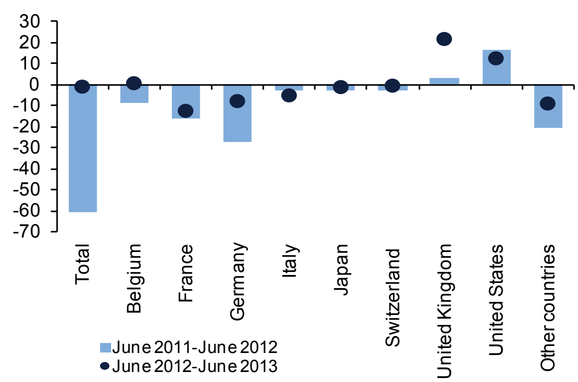
d) Foreign claims



e) Total other exposures



f) Total



Source: BIS and author's calculations.

Table 1

Variation in foreign bank's exposure to Spain

Variation June 2011- June 2012

	Foreign claims	Public sector	Banks	Non-bank private sector	Other potencial exposures	Total
a) Billions of euros						
All countries	-94.5	-18.1	-52.7	-24.7	34.1	-60.4
Belgium	-8.7	-2.0	-6.4	-0.3	0.3	-8.4
France	-13.5	-8.3	-8.6	2.6	-2.3	-15.8
Germany	-25.5	-1.2	-17.3	-6.9	-1.9	-27.4
Italy	-3.1	-0.2	-0.9	-1.9	0.1	-3.0
Japan	-1.3	-1.1	-1.1	0.9	-1.7	-3.0
Switzerland	-3.5	0.0	-0.4	-3.1	1.1	-2.4
United Kingdom	-8.1	-1.7	-2.7	-3.7	11.3	3.2
United States	-10.0	-0.5	-5.4	-4.2	26.9	16.9
Others	-20.8	-3.0	-9.9	-8.0	0.3	-20.5
b) Percentage variation (%)						
All countries	-18.5	-24.6	-33.8	-8.8	14.4	-8.1
Belgium	-52.5	-77.3	-69.7	-6.8	56.4	-49.1
France	-12.9	-39.6	-32.2	4.6	-8.7	-12.1
Germany	-20.7	-5.9	-36.2	-12.7	-6.1	-17.7
Italy	-14.8	-5.3	-19.4	-16.6	0.9	-9.6
Japan	-7.1	-14.6	-33.0	11.6	-48.2	-13.6
Switzerland	-19.8	-0.7	-5.7	-34.4	23.0	-10.5
United Kingdom	-11.6	-32.2	-21.7	-7.1	44.8	3.4
United States	-22.7	-9.0	-30.6	-19.5	21.9	10.1
Others	-58.8	-77.5	-72.8	-45.0	0.3	-13.1

Source: BIS and author's calculations.

Foreign banks' reaction to Spanish public debt exposure is of particular interest given its implications for the risk premium. In this case, the improvements taking place in the two periods examined, going from a reduction of the exposure of 18 billion euros to an increase of 2.7 billion is mainly due to French banks, which have gone from an 8.4 billion euro reduction in their holdings to an increase of 2.3 billion euros. The improvement in US banks' confidence also stands out, as their public debt holdings have risen by 2.7 billion euros since June 2012, compared with a drop in the 12 preceding months. Conversely, German and Italian banks' reduction in their exposure to Spanish public debt has continued, and even accelerated.

Table 1 (Continued)

Variation in foreign bank's exposure to Spain

Variation June 2012- June 2013

	Foreign claims	Public sector	Banks	Non-bank private sector	Other potencial exposures	Total
a) Billions of euros						
All countries	-20.2	2.7	9.7	-35.4	19.3	-0.9
Belgium	0.7	0.0	1.3	-0.6	0.0	0.7
France	-8.4	2.3	-0.2	-10.7	-4.0	-12.5
Germany	-4.0	-1.7	3.4	-5.7	-3.8	-7.8
Italy	-3.2	-1.4	0.8	-2.6	-1.9	-5.1
Japan	-2.6	0.2	-0.4	-2.3	1.4	-1.1
Switzerland	0.7	0.0	-2.0	0.3	-1.2	-0.5
United Kingdom	-0.8	-1.6	9.1	-8.3	22.5	21.7
United States	6.1	2.7	0.7	2.7	6.5	12.5
Others	-8.6	2.2	-2.9	-8.2	-0.3	-9.0
b) Percentage variation (%)						
All countries	-4.8	4.9	9.4	-13.8	7.1	-0.1
Belgium	8.6	-7.9	46.2	-12.4	2.5	8.0
France	-9.3	17.9	-1.1	-18.1	-16.3	-10.8
Germany	-4.2	-8.6	11.0	-12.1	-12.5	-6.1
Italy	-18.1	-32.9	20.8	-26.7	-18.2	-18.1
Japan	-14.9	2.3	-19.1	-26.8	79.1	-6.0
Switzerland	5.2	4.0	-28.5	4.2	-19.6	-2.3
United Kingdom	-1.3	-44.5	93.4	-17.1	61.6	22.1
United States	17.7	56.2	5.6	15.6	4.3	6.8
Others	-22.7	36.3	-21.8	-43.4	-0.2	-4.7

Source: BIS and author's calculations.

In the case of bank debt, there has also been a clear improvement in confidence in Spain, as the situation has quickly changed from a drop in the global banking system's exposure of 34% to a rise of 9%. By a wide margin it is British banks that have increased their holdings of Spanish bank debt most (93% or 9.1 billion euros) since the summer of 2012. German banks have also increased their exposure to Spanish banks, with exposure rising by 17 billion euros from June 2011 to June 2012, and subsequently rising a further 3.4 billion euros in the following twelve months.

From capital flight to recovery

The analysis carried out can be summarised as follows:

1. Although foreign banks reduced their exposure to Spanish public debt by 24.7 billion euros (24.6%) following the sovereign-debt crisis, since mid-2012 exposure has increased by 2.5 billion euros (4.9%).

2. From June 2011 to June 2012 the debt issued by Spanish banks held by foreign banks dropped by 33.8% (52.7 billion euros), while it increased by 9.4% (9.7 billion euros) over the following twelve months.

3. Foreign banks' holdings of Spanish corporate debt have fallen steadily since the end of 2010 (22% to June 2013). This is the logical consequence of deleveraging by businesses with initially high levels of debt.

These figures clearly show that the recovery in investors' confidence in Spain, highlighted by the increase in direct and portfolio investment, has also taken place in the specific case of foreign banks. Since the summer of 2012, with the ECB's giving its solid support to the euro, foreign banks have increased their holdings of debt issued by Spain's banks and public sector, in complete contrast with the capital flight that took place in the preceding months after the outbreak of the sovereign debt crisis in mid-2011. In the twelve months following the start of the crisis alone, foreign banks reduced their holdings of public and bank debt by 70.9 billion euros. By contrast, from June 2012 to June 2013 foreign banks increased their exposure to this type of debt by almost 12.5 billion euros.

This comparison, although it gives some cause for optimism and shows that the Spanish economy has passed a turning point, also obliges us to be cautious, as in cumulative terms, between the summer of 2011 and mid-2013, foreign banks had reduced their holdings of Spanish public debt by slightly more than 15 billion euros, with capital flight of 43 billion euros in the case of bank debt. The drop in foreign banks' exposures to Spanish private non-bank debt has also been significant (60 billion euros), although this reduction is also the product of the necessary deleveraging being undertaken by highly indebted Spanish businesses.

Going forward, this incipient recovery needs to gain traction, as at present, although we have emerged from recession, we have not yet left the crisis behind. Although Spain's deleveraging is necessary, in order to avoid its being excessively rapid and traumatic, foreign investors' confidence (including that of foreign banks) needs to be restored further so as to make it possible to borrow at reasonable rates. However, cutting Spain's cost of financing demands more, particularly that banking union progress rapidly so that Spain's banks, and by extension, its businesses, can obtain financing on better terms than currently available from Europe's fragmented financial market.