Spanish banks: Boosting solvency and performance ahead of the comprehensive assessment

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European supervision will commence this November with a comprehensive balance sheet assessment of the EU banking sector on the basis of December 2013 accounts. Most Spanish banks have already released their 2013 statements, allowing us to present in this article the results of a simulation exercise, which reveals improvements in the Spanish banking sector´s profitability and solvency ahead of the EU level review.

The IMF´s final progress report on Spain´s financial sector assistance program can be considered a bridge between the successful completion of Spain´s program and the beginning of European single supervision. The IMF essentially considers Spain´s financial sector assistance program to have been successful, while pointing out remaining challenges, such as the need to consolidate and monitor MoU progress, uncertainty´s surrounding the SSM assessment, and the unwinding of the government´s stakes in nationalized banks. Our analysis of a representative sample of Spanish banks shows that although the main challenge continues to be restoring lending to the private sector, the latest figures suggest that an inflection point may be reached in the following months and that by 2015, the growth in new loans may exceed repayment of outstanding credit. Moreover, the Spanish banks in our sample have increased their core capital ratios from around 9.35% in 2012 to 11.5% in 2013. The return-on-assets has also increased from -3.14% to 0.23% over the same period. In this context, we believe that the Spanish banking sector seems to be well-prepared for the comprehensive assessments and stress tests that will be conducted at the EU level this year. We add a word of caution, however, that there are two outstanding issues, which could affect Spain´s performance on the upcoming EU Comprehensive Assessment - the holdings of debt and some loan exposures. The ECB´s decision regarding the treatment of these issues, which remains to be finalized, could ultimately affect Spanish banking sector results.

The end of financial sector assistance and the beginning of privatizations

The IMF presented its final progress report on the financial sector assistance program to Spain on February 20th, 2014. As in previous assessments, the advances made were highlighted along with some remaining challenges. In our view, this report can somehow be considered as a bridge between two important stages for the Spanish

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Exhibit 1

IMF's view on the financial sector assistance program and the remaining challenges

POSITIVE OUTCOMES OF THE FINANCIAL ASSISTANCE PROGRAM	REMAINING CHALLENGES
Identification of undercapitalized banks (asset quality review + stress tests)	Enhanced monitoring and supervision ahead of the SSM
Recapitalizations and bail-ins	Boosting core capital to facilitate lending
Boosting asset quality and liquidity and creating SAREB	Avoiding impediments to asset disposal
Restructuring and resolution for state-aided banks	Deferred tax assets (DTAs)
Reforming Spain's frameworks for bank resolution, regulation, and supervision	SAREB: Effective liquidation strategies
Strengthening the system's capital, liquidity, and loan-loss provisioning	Savings bank reform: Governance
Improvement of financial market conditions	Europe's contribution to recovery

Source: Authors' own elaboration.

banking sector: i) the end of the EU-monitored reform program for banks; and, ii) the upcoming challenges for the sector, starting with the comprehensive assessment and stress tests that will be published by the European Central Bank (ECB) and the European Banking Authority (EBA) in November 2014. The IMF assessment and recommendations are summarized in Exhibit 1.

Overall, the IMF considers the financial sector assistance program a success story. It underlines that "the Spanish authorities' implementation of the program has been steadfast." Below, we describe the main elements of the report and its potential impact on the current status and future developments in the Spanish banking sector.

All the measures included in the Memorandum of Understanding (MoU) have been completed and, as shown in Exhibit 1, this includes key actions, starting with the identification of undercapitalized banks "via a comprehensive asset quality review and independent stress test." This first action is quite relevant as its usefulness is twofold. First, it represents transparency and disclosure from banks which have faced several corrective actions by regulators and supervisors. Second, it has set a very important precedent ahead of the ECB-EBA assessments in November 2014.

A logical consequence of the identification process has entailed requiring banks to address their capital shortfalls. At this point, this has not only included capital injections but also the bail-in of junior debt. The latter is quite relevant and timely in an environment of banking union consideration of the structure of creditor rights and bail-in measures.

The report also mentions the role of SAREB. On the positive side, the IMF notes that SAREB has contributed to reduce "uncertainty regarding the strength of banks' balance sheets and boosting liquidity by segregating state-aided banks' most illiquid and difficult-to-value assets", but also highlights remaining concerns and challenges, which we will address later on.

The IMF acknowledges that Spain is already adopting plans to restructure or resolve state-aided banks within a few years and, as we will show in this section, the partial privatization of Bankia is a relevant example.

On the supervision and regulatory side, the report highlights that Spain has made substantial progress in reforming the frameworks for bank resolution, regulation, and supervision "to facilitate a more orderly clean-up and better promote financial stability and protect the taxpayer." Such frameworks have strengthened the resolution power of the Bank of Spain and will also help Spain to more easily adapt to the single resolution framework within the European banking union project.

The reform and resolution process of the Spanish banking sector has not been voluntary and this has made it unique in Europe. However, the trade-off has been the speed of actions, since the main authority for crisis management –the FROB– was created in 2009, but no significant recapitalizations were made until 2012.

Another advance made according to the IMF refers to the improvement in the system's capital, liquidity, and loan-loss provisioning. As we have mentioned in previous editions of *Spanish Economic and Financial Outlook,* the reform and resolution process of the Spanish banking sector has not been voluntary and this has made it unique in Europe. However, the trade-off has been the speed of actions, since the main authority for crisis management –the Fund for the Orderly Restructuring of Spanish banks (FROB)– was created in 2009, but no significant recapitalizations were made until 2012. In any event, the final report of the IMF considers that the capital injections and loan-loss provisioning tools have permitted avoidance of the "deepening cycle of losses on deposits, accelerating deposit outflows, and more bank failures."

Along with these substantial improvements, the report observes that "financial market conditions have improved dramatically during the program, with risk premia on external borrowing by Spain's banks and sovereign down more than 75 percent and equity prices up more than 50 percent during the program period." At this point, it is worth mentioning that the IMF considers such improvement in sovereign market conditions a combination of "crisis-fighting measures adopted in Europe during the last 18 months (e.g., OMT)" and "Spain's financial-sector program."

Considering factors such as the comprehensive assessment of the ECB, Basel III requirements, and market appetite for bank solvency as a condition to access debt markets, banks have no other option but to reinforce their solvency today if they want to be able to restore lending as macroeconomic conditions improve.

As for the challenges, the report considers them to be a mix of the necessary long-term consolidation and monitoring of the progress of improvements made under the financial sector assistance program, and the "uncertainties arising from unknowns regarding the methodology of the Single Supervisory Mechanism's (SSM´s) upcoming comprehensive assessment, as well as the unwinding of the state's ownership interests in intervened banks over the next few years." Accordingly, the first recommendation for further action is to enhance "monitoring and supervision (...) including continued efforts to ensure adequate provisioning and to prepare banks for the SSM's forthcoming comprehensive assessment." It is worth noting that large Spanish banks have significantly reinforced their solvency in the last two years.

An important but controversial issue is considered within the recommendation of "boosting core capital to facilitate lending." At first glance, both actions may seem incompatible, as capital requirements make lending more difficult but the view here should be interpreted as a long-term one. Considering factors such as the comprehensive assessment of the ECB, Basel III requirements, and market appetite for bank solvency as a condition to access debt markets, banks have no other option but to reinforce their solvency today if they want to be able to restore lending as macroeconomic conditions improve.

The report also mentions the need to avoid impediments to asset disposal stating "another benefit of efforts to ensure adequate provisioning is that it should foster asset disposal over time (helping to free space on banks' balance sheets for new lending) and corporate debt restructuring (thereby reducing debt overhang), including increased conversion of corporate debt into equity. Tax reforms could further reduce impediments to asset disposal."

Along the same lines of reinforcing solvency, the IMF makes an explicit claim regarding deferred tax assets (DTAs). Spanish regulation has recently permitted banks to convert DTA into capital and this has made it easier for some of them to achieve the capital requirements on a fully-loaded Basel III basis. In this regard, the IMF considers that the fiscal effects of the "mechanism should also be closely monitored to ensure that they are minimal as expected." Although this assessment is a bit too general as to make a clear interpretation, it seems to suggest that Spanish banks will have to give more weight to sources of capital other than DTAs in reinforcing their solvency.

As for the flip side of the progress made with SAREB, noted previously, the IMF warns that "property price declines and the deterioration of loans' credit quality remain key challenges for SAREB's cash flow and profitability. Implementation of effective liquidation strategies will be critical going forward." This suggestion may be related to the assessments in the previous report on the need to improve SAREB management. On this point, it is worth mentioning that a significant overhaul of SAREB management has been recently undertaken and that several actions have also been conducted to make the strategies of the asset management company more flexible and anticipative.

A final challenge mentioned in the report refers to the savings banks' reform. However, the comments here are too general and much less focused than in other recommended actions as the IMF simply mentions that "a major reform to enhance savings banks' governance and reduce their risks to financial stability was passed in late 2013. Strong implementation is now key."

Another issue the IMF considers key, with which we agree, is that one of the main challenges partially beyond the outreach of the domestic authorities is "Europe's contribution to recovery." At this point, the report points out there should be "more monetary easing" from the ECB, "swift progress toward more complete banking union" and being "flexible to changing circumstances and maximize the return on the taxpayer's investment in state-aided banks."

The FROB received 1.30 billion euros from the sale of a 7.5% stake in Bankia on February 28th, 2014. This represented a relatively small but still significant recovery of the 22.42 billion euros capital injection into the bank from public funds.

Following the IMF report, another one of the most important events regarding the banking sector (and the abovementioned remaining challenges) was the partial privatization of Bankia. In particular, the FROB received 1.30 billion euros from the sale of a 7.5% stake in Bankia on February 28th, 2014. This represented a relatively small but still significant recovery of the 22.42 billion euros capital injection into the bank from public funds.

As for the specific details, the FROB sold 863.799 million shares of Bankia at a price of 1.51 euros per share, a 4.4% discount to the closing price on the day before the sale. Bankia said in a statement that "such a discount is normal in transactions of this kind and smaller than the discounts seen in similar recent transactions."

The shares were sold to institutional investors through a so-called accelerated book building process (which essentially is a process of generating, capturing, and recording the interest of investors for the shares). Demand for the placement amounted to over 2.5 billion euros. The bookrunners were UBS, Morgan Stanley and Deutsche Bank.

The FROB had a stake of 68.4% in Bankia-BFA before the sale and it owns 60.9% after the deal. Apparently, the plans are to gradually sell off further stakes to reduce the public participation in the bank to 50.01% this year. However, it has been announced that no other sale will be made before 90 days since the first one.

Considering the positive evolution of Bankia shares over the last few months (with an accumulated increase of around 28% in the first two months of the year) the transaction gains are estimated at 300 million euros.

Spanish banks in 2014: More than profits

During the first quarter of 2014, most of the Spanish banks presented their accounting statements as of December 2013. The statements are important not only to address the impact of the financial sector assistance program but also because December 2013 is the reference point for the balance sheets and income statements that will be considered in the comprehensive assessments and stress test of the ECB and the EBA and that will be published in November 2014.

Balance sheets have shrunk in 2013 by around 10.5% after growing in 2012, a natural consequence of the deleveraging process and more evident following the asset disposals made by some of these institutions after the implementation of the MoU.

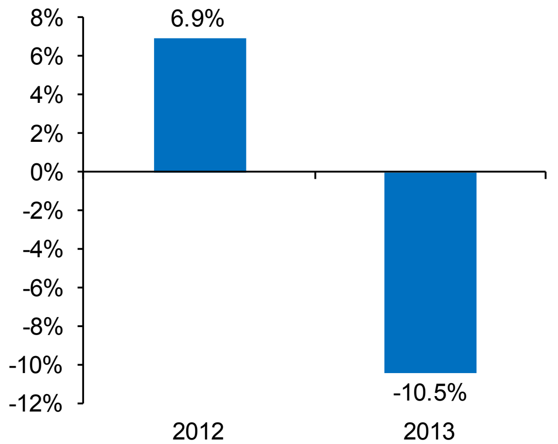
We have selected 15 banking groups for our provisional examination of the Spanish banking sector as of December 2013. The institutions included are Santander, BBVA, Caixabank, Bankia-BFA, Sabadell, Popular, Bankinter, NCG Banco, Catalunya Banc, Kutxabank, BMN, BMN, Banco Ceiss, Liberbank, Unicaja and Ibercaja. This exercise was based on consolidated balance sheets and income statements from December 2013. For those banks whose statements for December 2013 were not available, we used data from September 2013 as a reference. Moreover, we note that the figures may be subject to changes when the official data is released by the Banks themselves and the Bank of Spain. In the same vein, we have mainly focused on trends and variation from 2012 to 2013 rather than on absolute values.

The first element analyzed is asset growth. As shown in Exhibit 2, balance sheets have shrunk in 2013 by around 10.5% after growing in 2012. The shrinkage is the natural consequence of the deleveraging process of many of the institutions analyzed and was more evident following the asset disposals made by some of these institutions after the implementation of the MoU. This effect was less evident in 2012, due to corporate movements including mergers and acquisitions. In any event, the financial sector assistance program is not the only reason that explains the fall in the size of the whole sector. Overall, this change can be interpreted as a necessary adaptation of industry capacity to the reality of the demand for financial services following the crisis.

As suggested by the IMF report discussed above, asset disposal will continue to be a key strategic driver for some banks and, in particular, for some of those that were nationalized, as it is one of the main ways these banks can improve their solvency and performance and, in the case of privatizations, reduce the impact on taxpayers.

Exhibit 2

Asset growth in the Spanish banking sector



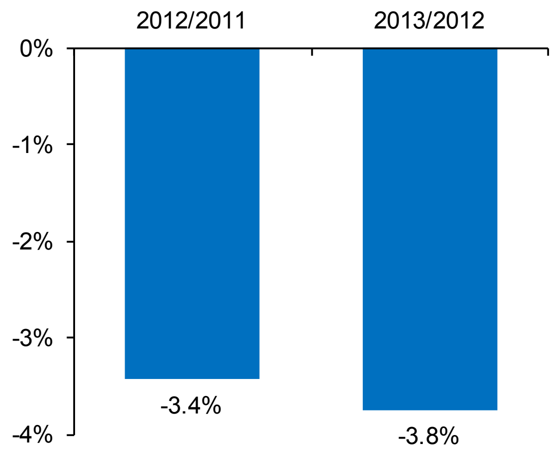
Source: Own estimations from a representative sample of Spanish banks.

Balance sheets have also contracted given the fall in one of the main assets which are customer loans. In our sample, loans fell by 3.4% in 2012 and by 3.8% in 2013, as shown in Exhibit 3. This is, in part, due to the number of loans that have been transfered to SAREB or to institutional investors as the process of cleaning-up of balance sheets has continued over the last two years.

However, as depicted in Exhibit 4, the decrease in lending to financial institutions (in this case taking

Exhibit 3

Growth in customer loans at Spanish banks



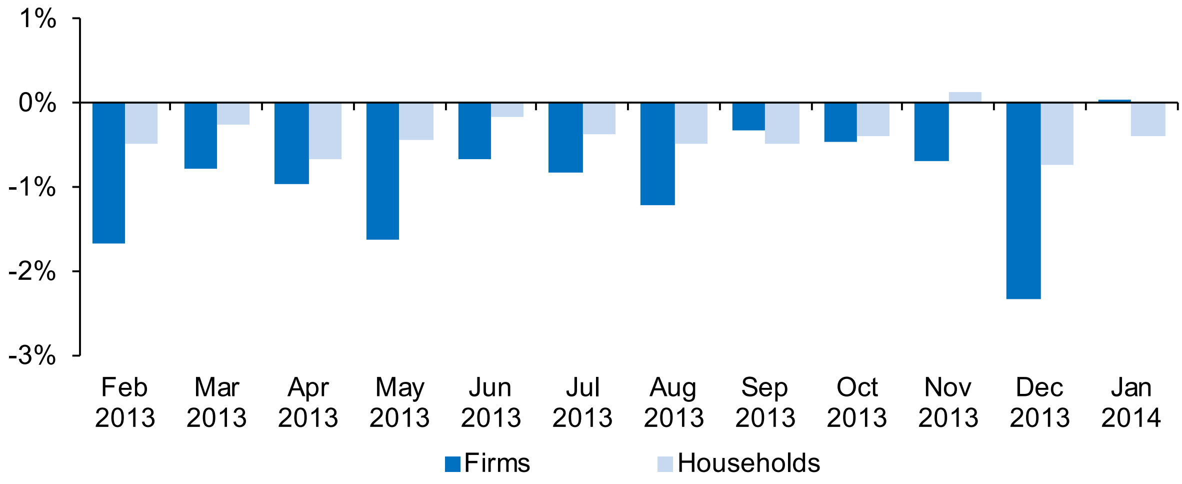
Source: Own estimations from a representative sample of Spanish banks.

the latest data provided by the Bank of Spain) suggest that an inflection point could be reached in the following months. Month-on-month, loans to firms have even increased in January 2014 with respect to December 2013, even if the change was as small as 0.03%. However, the repayment of the outstanding loans is accelarating as the private sector continues to delevarage and our estimation is that the growth in new loans to the private sector may exceed repayments by the first half of 2015.

Coming back to our sample, we also observe that customer deposits increased by 2.3% in 2012 and 4.5% by 2013 (see Exhibit 5). Even if there are distributional effects and this trend may be more significant for some market participants than others, it shows overall that banks have been pursuing strategies to reinforce their customer base and liquidity. Combined with the improved sovereign and funding market conditions and the cleaning-up of balance sheets, this trend may also help Spanish banks to increase the flow of credit.

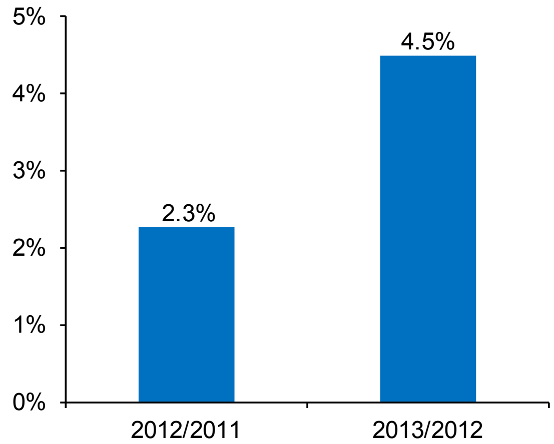
On a related note, one distinctive strategic feature of the Spanish banks in the European environment is their level of efficiency. In the previous edition

Exhibit 4
Month-on-month variation in lending to households and firms



Source: Bank of Spain and own elaboration.

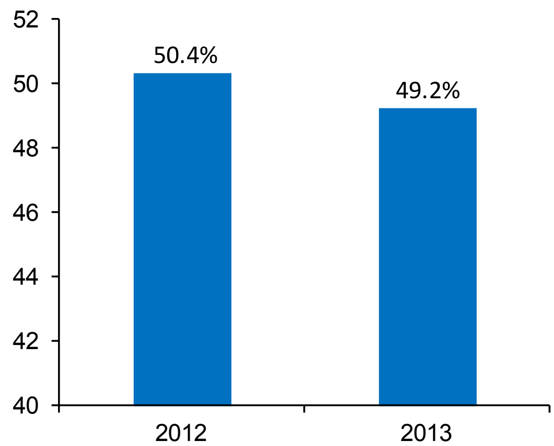
Exhibit 5
Growth in customer deposits at Spanish banks



Source: Own estimations from a representative sample of Spanish banks.

of *Spanish Economic and Financial Outlook,* we compared the performance and solvency of Spanish banks with their European peers, taking June 2013 as a reference. In that comparison, Spanish banks emerged at the top of the efficiency ranking in the EU. This improvement in operating efficiency seems to be continuing, as the cost-income ratio for our sample declined from 50.4% in 2012 to 49.2% in 2013 (see Exhibit 6).

Exhibit 6
Cost-to-income ratio at Spanish banks



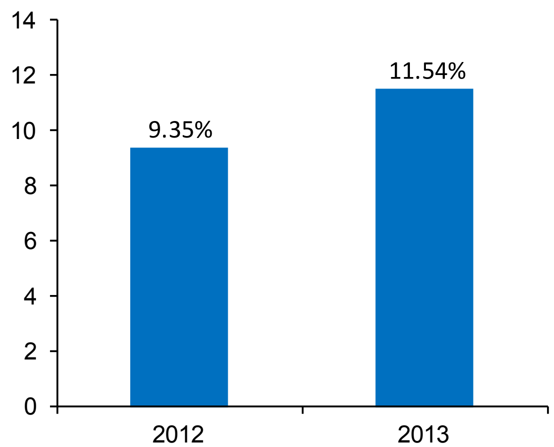
Source: Own estimations from a representative sample of Spanish banks.

One of the main reasons that motivated the EU financial assistance program for Spanish banks was solvency and the need to recapitalize part of the sector. Additionally, international markets seem to require banks to make an extra effort where solvency is concerned, in line with forthcoming Basel III requirements. Besides, as stated previously, the December 2013 figures are a key reference as they will be the ones used in the ECB's comprehensive assessment in November 2014. As noted in the IMF´s final progress report on the Spanish banking sector, "Another top priority is for supervisors to continue encouraging banks to build core capital in absolute levels—including by taking advantage of buoyant equity markets to boost share issuance, extending the dividend limit to 2014, and supporting profits through further efficiency gains. This will help avoid excessive reliance on credit contraction to support capital ratios, which would worsen already-tight credit conditions."

As we show in Exhibit 7 for our group of representative banks, the core Tier 1 ratio has increase significantly over the last year going from 9.35% to 11.54%. This improvement is due

Exhibit 7

Core capital ratio at Spanish banks



Source: Own estimations from a representative sample of Spanish banks.

to various factors including the reduction of assets (as shown above), the incorporation of DTAs and the effort of banks to allocate more resources to increase own funds.

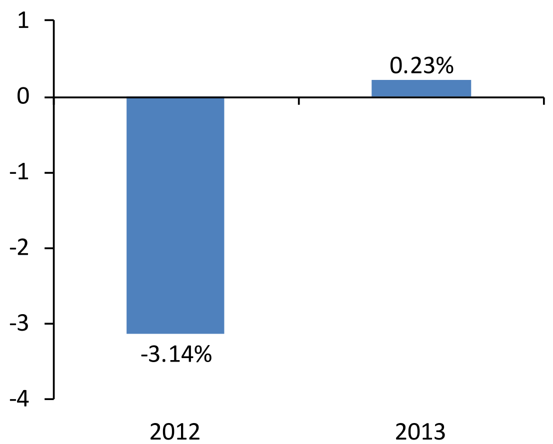
The improvement in profitability has also helped Spanish banks to boost their solvency, in particular following recommendations from the Bank of Spain where dividend policy is concerned.

Finally, another source of good news for Spanish banks in 2013 is that they are once again profitable. Taking relative figures for our sample estimation, the return-on-assets (RoA) has increased from -3.14% in 2012 to 0.23% in 2013 (see Exhibit 8). This improvement in profitability has also helped Spanish banks to boost their solvency, in particular following recommendations from the Bank of Spain where dividend policy is concerned. Importantly, the Bank of Spain has extended such recommendations to 2014. In a statement released on February 21st, 2014 "on credit institutions' dividend policy in 2014" the Bank of Spain underlines that "January 2014 saw the entry into force of the new European solvency regulations (known as CRR/CRD IV), which lay down more demanding rules for the oversight of banks' solvency. In turn, the European Central Bank (ECB) is, during 2014, to undertake a comprehensive assessment of the credit institutions of the Member States participating in the Single Supervisory Mechanism. Within this framework, the Banco de España deems it is advisable for banks to persevere with rigorous policies geared to capital conservation and the strengthening of solvency levels."

Specifically, the Bank of Spain recommends that the cash dividends paid out of 2014 earnings should not exceed 25% of attributed consolidated profit. This ceiling may, in exceptional cases, "be breached as long as the institution can substantiate a particularly favorable outlook for its margins and a level of its CET1 capital ratio higher, as of January 1st, 2014, than 11.5%, i.e. 3.5 percentage points above the CET1 level set as a benchmark for the comprehensive assessment of the European banking system to be undertaken by the ECB in 2014." As regards dividends paid in shares, the recommendation is that banks "should make an additional effort to moderate this type of remuneration so that total dividends move towards levels that are sustainable in the medium term."

Exhibit 8

Return on assets (RoA) at Spanish banks



Source: Own estimations from a representative sample of Spanish banks.

Summing up, even if the return to profits seems to be the noticeable headline, the most important development for the Spanish banking sector in 2013 is that a transformation is becoming evident. In particular, the industry has faced a significant number of regulatory and business challenges and seems to be well prepared for the comprehensive assessments and stress tests that will be conducted at the EU level this year. This situation is a combination of quantitative and qualitative issues. On the one hand, the effort made in terms of restructuring and recapitalization over the last years. On the other hand the transparency and disclosure exercises that have been conducted and that, in a way, mimic some of the requirements that Spanish banks may face in the comprehensive assessment of November 2014.