Has bank restructuring in Spain and Europe paid off?

Santiago Carbó Valverde[1] and Francisco Rodríguez Fernández[2]

The persistence of the credit crunch in the euro area, the uncertainty surrounding economic conditions and the ECB´s upcoming comprehensive assessment of banks underpin the common belief that a high degree of restructuring is still pending in the European banking sector. Spain´s more intense restructuring process relative to other countries probably explains increased competitive advantages for the Spanish banking sector.

Our analysis suggests that deleveraging is a major trend in Europe as the total assets of the banking sector in the euro area fell by 8% in 2013. Such a trend is expected to continue in 2014 and it will be likely reinforced by the ECB´s upcoming comprehensive assessment of banks. However, deleveraging does not only respond to regulatory pressures. It is also explained by the lack of bank restructuring in many European countries. Restructuring has not been in line with service capacity (measured by the fall in bank branches). In the case of Spain, adjustment between 2008 and 2009 reached 17%, while much more limited corrections have been observed in other large EU countries. Some of the estimates we provide in this article suggest that restructuring pays off, as Spanish banks have substantially improved their profits and efficiency relative to other European banking sectors and are currently enjoying larger economies of scale.

Restructuring as a strategic driver for the European banking sector

The health of the banks has again become a key issue for the European economy. Part of the reason is the comprehensive assessment of banks that the ECB will undertake in November 2014. This assessment will represent the debut of the ECB as the single supervisor within the European Banking Union. One of the main objectives of this analysis is to determine if EU banking sectors are in good enough condition to reestablish and reinforce the link between the financial system and the real economy.

As uncertainty remains surrounding the banks´ financial conditions, the ECB analysis is expected to offer some insights on the solvency of the euro area banks. The remaining doubts are motivated by a number of facts. One of them is the substantially unequal way in which the governments and supervision authorities in the euro area countries have implemented resolution mechanisms to restore financial stability. The resolution alternatives have largely been a combination of recapitalization and restructuring measures. As shown in Exhibit 1, there have been three main ways in which recapitalization and restructuring have been combined. One of the alternatives has been to develop an orderly

[1] Bangor Business School and Funcas.
[2] University of Granada and Funcas.

restructuring of the banks and a slow and late recapitalization, as in the case of Spain. The main problems related to this approach have been the probably larger bailout costs assumed for a late recapitalization as opposed to the costs that could have been assumed with prompt injections of capital. Additionally, such delay has also contributed to the need for a European assistance program for the banking sector, including a comprehensive set of conditionality measures. The advantages, however, have been an orderly planning of a new structure for the banking sector, which has implied a considerable correction of excess supply capacity.

A second model has been one combining an early recapitalization with a late restructuring. This has been, for example, the case of Ireland. Back in 2008 and 2009, Irish banks received large capital injections. However, the authorities soon realized that the solvency status of the banks was even worse than expected. The estimated losses calculated by the National Asset Management Agency (NAMA), Ireland´s bad bank, fell short. The capital needs were ultimately much higher, triggering Irish sovereign debt to reach record levels and motivating an EU-wide external assistance program for the country, including conditionality on both the banking sector and fiscal policies.

Finally, a third model combines early recapitalization with little to no restructuring. Germany and the U.K. are the main examples here. Considerable capital injections were made in 2008 and 2009 and, particularly in the U.K., some big banks were nationalized. However, the profitability and solvency of these and other banks in those countries have not improved as expected and some additional capital needs may emerge. Moreover, those banking sectors have not been subject to substantial restructuring measures even if the market analysis suggests there is a clear mismatch between supply and demand of financial services.

The heterogeneous effects of the different resolution alternatives have left the European banking sector with some pending work to be done in this area. In particular, there is still significant space for further restructuring and deleveraging. The supervision authorities are aware of this, and industry figures also show that restructuring is still a major trend in the EU banking industry.

Exhibit 1

Three ways of combining recapitalization and restructuring in European banking

Orderly restructuring and slow recapitalization	Early recapitalization but late restructuring	Early recapitalization but little restructuring
• Case: Spain. • Problems: Increasing bailout costs due to late intervention, EU conditionality. • Advantages: Orderly planning of the banking sector, European support, effective restructuring that corrects excess capacity.	• Case: Ireland. • Problems: Insufficient early recapitalization exacerbates credibility problems, larger bailout costs, EU conditionality. • Advantages: Gradual recovery of credibility with the EU-assistance program.	• Cases: Germany, U.K. • Problems: Lack of restructuring makes the sector unprofitable and likely to need further recapitalization. • Advantages: Little or no EU conditionality.

Source: Author’s own elaboration.

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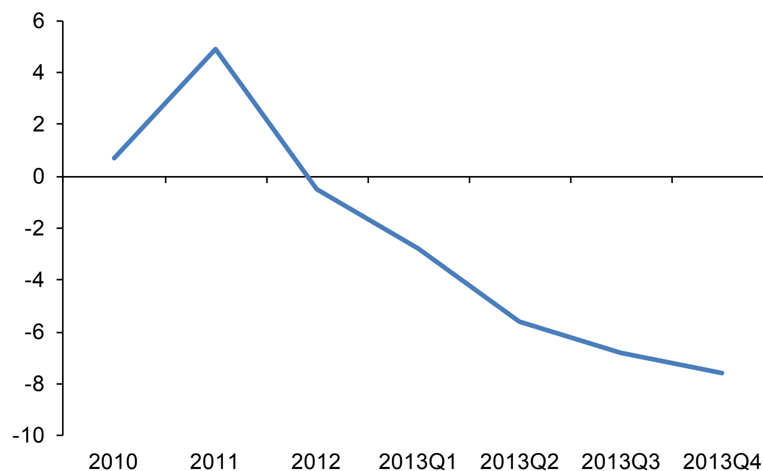
Mario Draghi´s recent speech at the Schumpeter Award ceremony, hosted by the Austrian Central Bank on March 13th, 2014,[3] illustrates this issue. Mr. Draghi made three points that deserve specific attention:

First, the extent to which deleveraging is still considered to be a major driver of banks´ strategic planning. In particular, one excerpt mentions that "from a policy perspective, the question presented to us is not whether we can avoid this deleveraging. It is universally accepted that too much debt had been built up in the run up to the crisis, by governments, non-financial firms, households and banks, and that we now have to work through the effect of the subsequent debt overhang. The correct question, in my view, is what form this deleveraging should take, and at what speed it should be allowed, or encouraged, to take place. Clearly, we do not want any excessively rapid deleveraging that involves disorderly fire sales of assets (...) At the same time, we do not want any excessively prolonged deleveraging, where banks reduce their loan book by curtailing new lending, while hoping that the underperforming assets they hold recover in value. Put bluntly, this would create "zombie" banks that do not lend, and the longer this persists, the longer credit conditions will interfere with the process of creative destruction described by Schumpeter. The "churn" process between firms entering and exiting the market that is a crucial driver of productivity would be disrupted." Hence, there seems to be a "good" (debt correction and financial stability enhancing) deleveraging *vs.* a "bad" (credit restrictive) deleveraging. Indeed, as shown in Exhibit 2, the total assets of the euro area banking

Exhibit 2

Total assets of banks in the euro area (annual growth, %)



Source: ECB and own elaboration.

[3] The title of the speech was, *Bank restructuring and the economic recovery* and it is available at: http://www.ecb.europa.eu/press/key/date/2014/html/sp140313_1.en.html

sector have been significantly diminishing since 2012 and by the end of 2013, the annual fall in total assets was estimated at 8%.

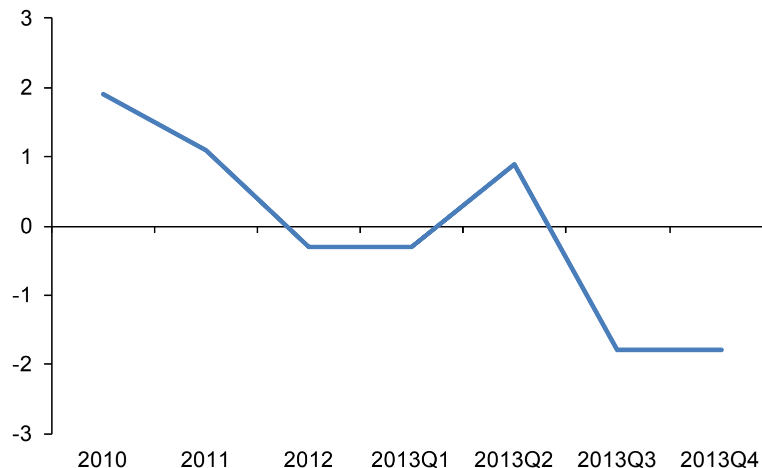
Second, such a significant deleveraging is having an impact on loan growth. As Mr. Draghi mentions, "there is some evidence that such credit misallocation is already occurring in the euro area, and it is creating an undesirable, even if only temporary, distortion to the detriment of small firms. Unlike large firms, small and medium-sized enterprises (SMEs) cannot easily replace bank funding with capital market financing. Banks perform a key role in reducing information asymmetries with respect to the creditworthiness of smaller borrowers." Exhibit 3 seems to confirm that the credit crunch in the euro area has intensified in 2013. This should be related to the deleveraging trend which, at the same time, is being fostered by the increasing solvency requirements ahead of the ECB´s comprehensive assessment in November 2014 and Basel III regulations.

Finally, it seems that the recapitalization of the European banking sector is still incomplete. However, this is not only due to the increasing regulatory pressures and the intensity of the supervision enforcement but also to the need for implementing further restructuring in many European banking sectors. As Mr. Draghi pointed out, "our comprehensive assessment of bank balance sheets is, in my view, creating the setting and incentives for achieving this. The assessment will shed light on bank assets, ensure that problematic assets are fully recognized and prompt timely corrective action in the form of bank restructuring and capital replenishment. (...) Well–capitalized banks are better able to end or restructure loans to firms with bad credit standing. This in turn ought to facilitate the process of selection of the firms that deserve to survive because they can thrive. Of course, credit conditions are not the only obstacle to innovation, and it is important to emphasize the role of structural and tax reforms in creating a business climate that is conducive to investment and job creation. Cleaning-up banks is not a sufficient condition for a return to sustained growth– but it is a necessary condition."

Therefore, bank restructuring implies both a proper clean-up of the assets in a given banking

Exhibit 3

Loans to the private sector of banks in the euro area (annual growth rate, %)



Source: ECB and own elaboration.

sector as well as the setting of a necessary equilibrium between demand and supply, by

Bank restructuring implies both a proper clean-up of the assets in a given banking sector as well as the setting of a necessary equilibrium between demand and supply, by reducing the number of providers, mostly by integration processes and by asset deleveraging.

reducing the number of providers, mostly by integration processes and by asset deleveraging. Such processes have been widely discussed in previous issues of *Spanish Economic and Financial Outlook*. In any event, as a reference to illustrate how heterogeneous they have been, Exhibit 4 depicts the evolution of the ratio of bank branches in 2012 to the bank branches in 2008. This indicator reveals that Spain has adjusted its service capacity by 17% in five years, while other countries, such as Germany or the United Kingdom, have only reduced their branches by 5% and 3%, respectively.

It is worthwhile considering the evolution of the branching network along with the evolution of the number of employees. In this context, the adjustment in the branch infrastructure has been accompanied by a reduction of 42,205 employees in Spain from 2008 to 2012. However, in other

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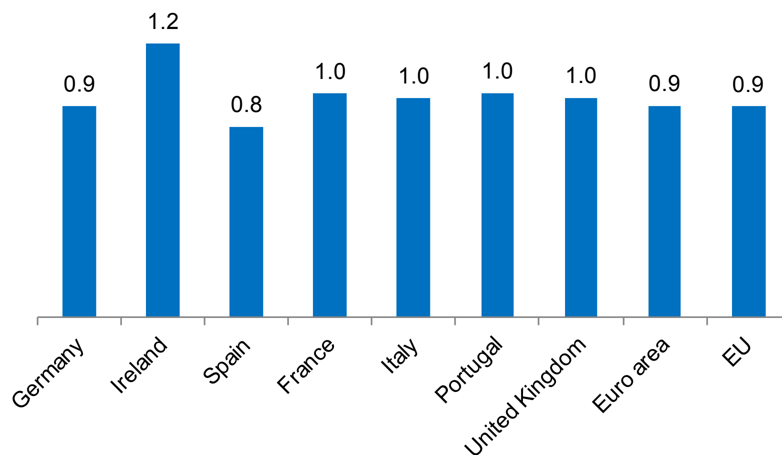
countries where the adjustment in the branch network has been rarely observed, the reduction in personnel has also been substantial. This is, for example, the case of Germany (-26,450 workers), Italy (-28,495) or the United Kingdom (-54,225). Such sharp contrast between no adjustment in network infrastructure and a substantial reduction in the work force suggest that many European banks are reluctant to truly adopt restructuring processes. Ultimately, the costs of the lack of restructuring have been assumed by the employees in those countries, while the structure

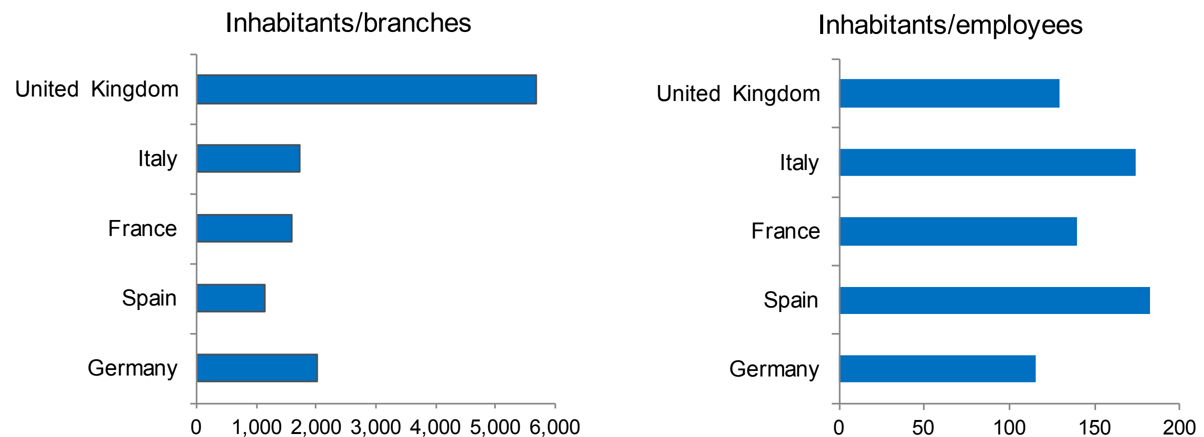
Exhibit 4

Ratio "branches 2012/branches 2008" in selected European banking sectors



Source: ECB and own elaboration.

Exhibit 5
Capacity indicators for selected European banking sectors



Source: ECB and own elaboration.

of the industry still needs to be corrected to a large extent.

Exhibit 5 suggests that the reduction of branches in Spain has permitted a certain "normalization" of service capacity so that the banking sector now has one of the lowest ratios of "inhabitants/branches" and one of the largest of "inhabitants/employees".

Upcoming stress tests reveal EU supervisor´s perceptions about banks´ operating climate

The previous section has described the restructuring process in Europe somehow as an endogenous process. However, there are also exogenous factors that have explained the variety of options and the uneven adjustment made across the European banking sectors. A major one is macroeconomic conditions. In April 2014, the European Banking Authority (EBA) released its methodology and macroeconomic scenarios for the 2014 EU-wide stress test, which will be one of the main elements of the comprehensive assessment of banks coordinated by the ECB.

One important feature regarding the EBA tests is that the macroeconomic scenarios designed reveal to some extent the perceptions of the European supervisor on how the economy can impact banks over the next years. As consumer choices "reveal" their relative preferences for some goods, the macro scenarios reveal the perceptions of the euro area supervisor about the environment in which banks will operate in the near future. In this sense, one interesting analysis consists in comparing the conditions envisioned for Spain with those of the euro area and the European Union. We make such analysis taking the worst–case scenario as a reference: the so–called "adverse scenario". The adverse scenario, according to the EBA, "reflects the systemic risks that are currently assessed as representing the most pertinent threats to the stability of the EU banking sector: (i) an increase in global bond yields amplified by an abrupt reversal in risk assessment, especially towards emerging market economies; (ii) a further deterioration of credit quality in countries with feeble demand; (iii) stalling policy reforms jeopardizing confidence

Table 1

Macroeconomic adverse scenario for the stress tests of November 2014 (%)

		GDP growth	Inflation	Unemployment	Residential property prices
	2014	-0.3	0.3	26.3	-7.4
Spain	2015	-1.0	0.4	26.8	-3.0
	2016	0.1	0.8	27.1	0.9
	2014	-0.7	1.0	12.3	-8.0
Eurozone	2015	-1.4	0.6	12.9	-5.7
	2016	0.0	0.3	13.5	1.5
	2014	-0.7	1.1	11.3	-7.9
European Union	2015	-1.5	0.6	12.3	-6.2
	2016	0.1	0.0	13.0	-2.1

Sources: ECB and national central banks.

in the sustainability of public finances; and (iv) the lack of necessary bank balance sheet repair to maintain affordable market funding."

As shown in Table 1, the adverse scenario seems to be "milder" for Spain compared to the euro area or the European Union average for most of the indicators considered with the only exception of unemployment. That means that, at least where economic growth is concerned, the future for Spanish banks does not impose further macroeconomic pressures as compared to other EU banking sectors where, in turn, bank restructuring is still pending.

Does it pay to restructure a banking sector?

As noted in the previous sections, bank restructuring can respond to a variety of factors. No matter if the reasons for the relatively larger restructuring in Spain are endogenous or exogenous, a relevant question would be – does it pay to restructure? The answer seems to be "yes" for various reasons. First, the clean-up of balance sheets and the new structure of Spanish banks in part contributed to restore confidence in the Spanish financial system and, subsequently, to the improvement in the funding costs of the country.[4]

A second reason is that Spanish banks have considerably improved their performance, even in a macroeconomic environment which is recovering but is still tough. As shown in Table 2, Spanish banks were among the most profitable in 2013 and also they were the most efficient. Additionally, their solvency is also better and is reaching the EU average.[5]

Finally, there is another benefit to restructuring – it contributes to matching the capacity of the banking sector to the demand for financial services. A good proxy of such improvement is economies of scale, which are estimated as the change in

[4] See the previous issue of *Spanish Economic and Financial Outlook* for a reference on how the listed Spanish banks have improved their market value over the last year and how the country risk premium has also fallen.

[5] Some more recent developments have also contributed to the increase in bank solvency in Spain, including the setting of rules to include differed tax assets as own resources and the limitations on dividend payouts set by the Bank of Spain.

Table 2

Country-level indicators: Profitability, efficiency and solvency indicators (2013) (% total assets)

	Germany	Ireland	Spain	France	Italy	Netherlands	Portugal	UK
Net interest income [full sample]	0.76	0.55	1.70	1.05	1.40	1.21	1.08	0.90
Total operating income [full sample]	1.52	1.05	2.82	2.09	2.84	1.58	2.17	2.10
Cost-to-income ratio [%]	-70.93	-63.73	-50.07	-67.68	-61.09	-63.29	-67.25	-63.40
Return on equity [%]	5.61	-4.50	8.02	6.85	1.39	5.34	-7.38	7.03
Return on assets [%]	0.20	-0.30	0.49	0.35	0.10	0.24	-0.47	0.37
Tier 1 ratio	14.78	17.38	10.76	12.64	10.92	12.78	11.71	13.18

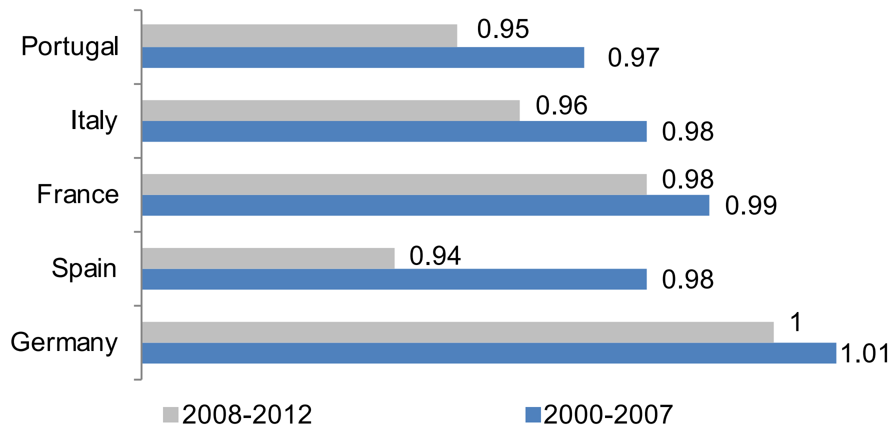
Sources: ECB and national central banks.

average costs given a unit change in total assets. Taking a representative sample of EU banks from the Bankscope database, we have estimated economies of scale in various European banking sector. The cost function has been estimated using a Fourier Flexible form. Economies of scale are found when their estimated value is smaller than 1, while diseconomies exist when the estimated value is larger than 1.

A common observation in most banking studies before the crisis was that the potential for economies of scale was exhausted in most European banking sectors. Our estimations –shown in Exhibit 6–

Exhibit 6

Economies of scale in the European banking sectors



Source: Authors' own estimation.

confirm that observation but reveal that some economies of scale have emerged in the last few years being much larger in the countries where restructuring has been more intense, as in the case of Spain. In particular, Spanish banks currently enjoy a 5% potential to reduce their costs by increasing their assets, while this advantage does not exist in Germany and it is very limited (below 2%) in other countries, such as France.

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Overall, our analysis suggests that the intense restructuring process that Spanish banks have gone through in the last years has imposed many sacrifices, but it may also bring many competitive advantages in the near future. It is actually already yielding significant benefits, but the most important ones are still to come, such as those related to the increase in lending to the real economy.