Fostering lending and promoting asset quality in Spain: The difficult task of reconciling overlapping policy objectives

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The ECB now faces the challenge of promoting the goals of bank solvency, while reactivating euro area credit flows. For the latter to be successful, Europe will need more risk-sharing mechanisms in the context of continued improvement in economic conditions.

The ECB is effectively assuming its role as single supervisor in November, at a time when its obligations as monetary authority are particularly relevant. This has resulted in the difficult task of simultaneously reconciling two distinct, overlapping policy objectives. On the one hand, the ECB will be promoting bank solvency and will be conducting stress tests and asset quality reviews. On the other hand, it is trying to stimulate lending by, inter alia, setting targeted long-term refinancing operations (TLTRO) and announcing a purchase program for securitized assets. The case of Spain is particularly interesting in this context, as the country has recently implemented a number of measures for bank restructuring and recapitalization, which leave it well prepared to face the European-wide stress tests and could favor the use of the TLTRO mechanism. The estimations on Spanish banks´ use of the TLTROs range from 30 to 50 billion euros. As for the asset purchase program, 13.81% of the outstanding value of one of the most important securities, residential mortgage backed securities (RMBS), were issued by Spanish banks and the potential for liquidity generation is more significant than initially expected. However, the establishment of some risk-sharing controls could help make both programs more effective. At the same time, unemployment remains high and there is uncertainty on the strength of the economic recovery process in the entire euro area. These factors may further affect the quality of loan demand.

Overlapping policy aims

Fall 2014 represents an inflection point for the European banking sector. The information requirements for the ECB's comprehensive assessment of the euro area banks will be completed. A first reference will be the stress tests coordinated by the European Banking Authority. The results will be presented in the second half of October before the full assessment is conducted by the single supervisor in November. At the same time, the European economy still shows signs of

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weakness and inflation remains too low. These circumstances have moved the ECB to act as monetary policy authority combining standard and extraordinary actions aimed both to push prices up and to stimulate bank lending.

Hence there are two faces of the ECB as single supervisor and monetary authority that have caused the overlapping of two relatively difficult to reconcile policy objectives. On the one hand, the ECB will be promoting bank solvency which, in practical terms should accelerate bank deleveraging and, therefore, shrink banks' balance sheets. On the other hand, the most favorable lending conditions created with the recent monetary policy actions –including targeted long-term refinancing operations (TLTRO) specifically designed to foster bank lending to the private sector– will also be taking place. This creates an unprecedented and particularly interesting framework of analysis. Spain is a good laboratory to explore the outcomes for various reasons. First of all, it is a country where unemployment remains high and this creates problems for both loan supply –as lending filters should prevent banks from too risky transactions– and loan demand –as solvent applicants are not abundant. Second, the Spanish economy is currently undergoing a process of economic recovery precisely when most of the other large single currency members are not at their best in terms of GDP growth and are putting the entire euro area at the risk of a triple-dip recession. Third, Spain has recently completed the implementation of a number of bank restructuring and recapitalization measures, and some of them include some long-term actions that will also overlap with the two policy objectives of the ECB. They include, inter alia, the privatization of State-owned banks, and transactions of the asset management company created to deal with troubled bank loans and assets (the so-called Sareb).

This article surveys the aforementioned trends from the Spanish perspective. It first looks at the recent development in the restructuring process of the Spanish banking sector. It follows with an analysis of the latest developments regarding the EBA-ECB stress tests and the situation of the Spanish banking sector in terms of deleveraging, solvency, and profitability. It also analyses the first TLTRO conducted by the ECB in September and tries to assess how this action could affect loan growth at Spanish banks. Finally, it studies the potential impact of the ECB asset purchase program in a country like Spain where some of the targeted securities are particularly relevant.

Recent developments in the restructuring of the Spanish banking sector

The remaining duties of the restructuring process of the Spanish banking sector include the privatization of State-owned banks where the Spanish resolution fund (the FROB) still has a majority stake. This was the case of the sale of Catalonia Banc by the FROB, a decision that was adopted on July 21st, 2014. The Governing Committee of the FROB, after studying the binding bids received in the process to sell Catalonia Banc, decided to award this institution to BBVA. The bid by BBVA was for 1.18 billion euros, for 100% of the capital of Catalonia Banc. The bid envisages the possibility of limiting the transfer to 98.4% of the shares, which are those corresponding to the FROB and to the Deposit Guarantee Fund, with the price being duly adjusted.

The FROB made clear that no special guarantees were provided to BBVA with this sale. In particular, it notes that "the terms of the sale agreement essentially observed the package of basic assurances offered by the FROB in the process, which does not include the granting of an asset protection scheme."

The bid by BBVA exceeded the thresholds set by the FROB for the sale. As a consequence, it was not necessary to go to a second round of offers by interested bidders. The FROB also mentions that the sale was approved following the standard conditions agreed with European authorities. In particular, the note released mentioned that "the objectives and principles of the restructuring and resolution of credit institutions set by the national and European authorities, and aimed at minimising State aid, have been observed. In turn, the stability of the financial system as a whole is ensured."

As for other relevant developments in this context, the FROB has also confirmed that another round of sales for the partial privatization of another of the State-owned banks, Bankia, will take place in October.

Stress test guidelines and the situation of the Spanish banking sector

A first big challenge for euro area banks this fall will be the stress tests coordinated by the European Banking Authority (EBA) as one of the main ingredients of the asset quality review (AQR) conducted by the European Central Bank (ECB). On August 8th, 2014, the ECB published a manual detailing how it will incorporate findings from its AQR into stress test projections. It also described the stress test quality assurance process, which, according to the ECB "is vital to ensuring that the exercise is robust and credible." Recall that the ECB's comprehensive assessment differs from previous EU-wide stress test exercises in that it comprises a thorough asset quality review and includes a "join-up" of the AQR and stress test outcomes.

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The quality assurance of the stress test focuses on delivering results that are "accurate, consistent and credible." This involves various relatively complex information management processes. In particular, several quality checks will be performed in cooperation with national authorities. The ECB will compare findings for individual banks with those of their peers and will apply its own top-down stress test model. Banks may be required to provide further evidence as part of a "comply or explain" approach. The manual underlines that the impact of the AQR on the stress test calculations works through multiple channels. For example, findings from the portfolios examined in the AQR will be used to determine the starting point of the stress test and, for the purpose of the exercise, and this may even lead to an adjustment to the year-end 2013 balance sheet. This was one of the main issues that were announced with the publication of the manual.

Additionally, where evidence from the AQR points to a bank having insufficient provisions, this will be reflected in adjustments to the bank's simulated projected losses in 2014, 2015 and 2016 for both the baseline and adverse scenarios. In addition, it will have an impact on the simulated profits and losses under stress test scenarios. It was also confirmed that the final results from the comprehensive assessment will be published in the second half of October.

On August 20th, 2014, the EBA published final templates for the stress test, showing the type and the format of data that will be disclosed on a bank by bank basis. The level of detail in the templates is high so that the EBA pointed out that, "in its role of coordinator of the stress test, it will be publishing up to 12,000 data points per bank across the entire EU, acting as the single hub for all information related to stress test outcomes of EU banks, as determined by competent authorities."

Amongst the information required from banks by the EBA, the templates include the composition of capital, risk weighted assets (RWAs), profit and loss (P&L), exposures to sovereigns, credit risk and securitisation. Importantly, for the first time, the EBA will disclose an illustrative fully loaded

Common Equity Tier 1 (CET1) capital ratio for each bank, which complies with the most recent EU Directives (CRR/CRD4). The time framework covered in the stress test will go from end 2013 to end 2016.

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How are Spanish banks preparing for the stress test and AQR challenge? As noted in previous volumes of the *Spanish Economic and Financial Outlook* (SEFO), the restructuring and recapitalization process has been particularly intense in Spain and has included its own supervision from EU authorities including asset quality reviews and stress test. This has created the expectation that Spanish banks will be ready to face these assessments in particularly good conditions. However, this involves a substantial effort. The final list of "significant credit institutions" that will be subject to the AQR and the stress test was published by the ECB on September 4th and includes 15 Spanish institutions (see Table 1).

A first and obvious way in which Spanish banks are facing the regulatory scrutiny challenge is a combination of asset deleveraging and equity increase. This is illustrated in Exhibit 1. The assets of the Spanish banking sector have recently fallen, and particularly since the implementation of the terms for the Memorandum of Understanding signed with EU authorities and containing the conditions for the financial assistance to the Spanish banking sector. Total assets have fallen from 3.25 trillion euros in 2012 to 2.84 trillion euros in

Table 1

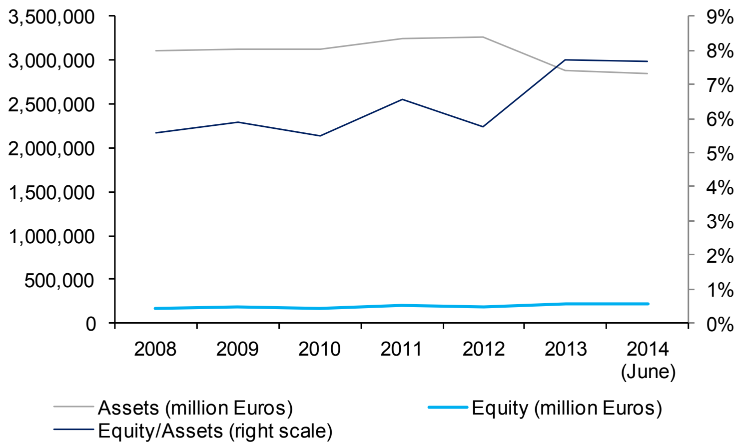
List of Spanish significant credit institutions for the ECB comprehensive assessment (asset category in parentheses)

Banco Bilbao Vizcaya Argentaria, S.A Size (total assets EUR 500-1,000 bn)
Banco de Sabadell, S.A. Size (total assets EUR 150-300 bn)
Banco Financiero y de Ahorros, S.A. Size (total assets EUR 150-300 bn)
Banco Mare Nostrum, S.A. Size (total assets EUR 50-75 bn)
Banco Popular Español, S.A. Size (total assets EUR 100-125 bn)
Banco Santander, S.A. Size (total assets above EUR 1,000 bn)
Bankinter, S.A. Size (total assets EUR 50-75 bn)
Caja de Ahorros y M.P. de Zaragoza, Aragón y Rioja Size (total assets EUR 50 -75 bn)
Caja de Ahorros y Pensiones de Barcelona, S.A. Size (total assets EUR 300-500 bn)
Banco de Crédito Social Cooperativo Size (total assets EUR 30-50 bn)
Catalonia Banc Size (total assets EUR 50-75 bn)
Kutxabank, S.A. Size (total assets EUR 50-75 bn)
Liberbank, S.A. Size (total assets EUR 30-50 bn)
Banesco Holding Hispania Size (total assets EUR 50-75 bn)
Unicaja Banco, S.A. Size (total assets EUR 75-100 bn)

Source: European Central Bank and own elaboration.

Exhibit 1

Assets and equity in the Spanish banking sector



Source: Bank of Spain and own elaboration.

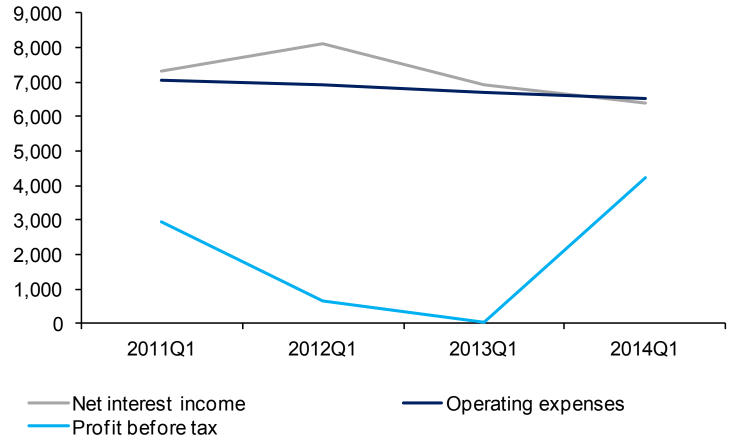
June 2014. This represents a 12.6% fall in two and a half years. However, equity has increased by 17.1% in the same period, from 186.8 billion euros in 2012 to 218.7 billion euros in June 2014.

Taking both trends –deleveraging and equity growth– together, this has resulted in an improvement of the equity/assets ratio from 5.7% in 2012 to 7.7% in 2014.

Pressure is not only being placed on solvency but also on margins. As shown in Exhibit 2, taking 2014Q1 as the most recent reference, the net interest margin has fallen by 21.1% since 2012Q1 (8.1 billion euros) to 2014Q1 (6.4 billion euros). This has led Spanish banks to make an extra effort in terms of efficiency improvements, reducing operating expenses by more than 6% in the same period. Given that most of the asset impairment

Exhibit 2

Bank margins and profits at Spanish banks (million Euros)



Source: Bank of Spain and own elaboration.

and related provisions were already accounted for in 2012 and 2013 –and the relatively improved market conditions in 2014– Spanish banks have been able to increase their profits substantially. Quarterly profit before tax has grown from 0.6 billion euros in 2012Q1 to 4.2 billion euros in 2014Q1.

Given that most of the asset impairment and related provisions were already accounted for in 2012 and 2013 –and the relatively improved market conditions in 2014– Spanish banks have been able to increase their profits substantially. Quarterly profit before tax has grown from 0.6 billion euros in 2012Q1 to 4.2 billion euros in 2014Q1.

All in all, it seems that the Spanish banking sector has already passed the inflection point and it is well prepared to face the challenges ahead. However, as we will show in the next section, this will not imply an immediate and complete recovery of lending growth rates.

The ECB's TLTRO: Is lending back?

In this section, we turn to the second policy objective –the promotion of bank lending as a tool to stimulate economic growth in Europe. A first relevant decision was adopted by the Governing Council of the ECB on June 5th, 2014. In particular, it announced the targeted longer-term refinancing operations (TLTROs). As noted by the ECB, the TLTROs "are designed to enhance the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy."

The TLTRO works as a sequence of linked programs. Banks will initially be able to borrow an amount equivalent to up to 7% of a specific part of their loans in two operations in September and December 2014. Additional amounts can be borrowed in further TLTROs, depending on the evolution of the banks' eligible lending activities in excess of the so-called "bank-specific benchmarks." In particular, additional borrowing allowance is limited to three times the difference between the net lending since April 30th, 2014, and the benchmark at the time it is claimed.

The benchmarks were set as follows: for banks that exhibited positive eligible net lending in the twelve-month period to April 30th, 2014, the benchmarks are always set at zero. For banks that exhibited negative eligible net lending in the year to April 30th, 2014, different benchmarks apply. First, the average monthly net lending of each bank in the year to April 30th, 2014, is extrapolated for 12 months until April 30th, 2015. Second, for the year from April 30th, 2015, to April 30th, 2016, the benchmark monthly net lending is set at zero.

Banks that borrow in the TLTROs and fail to achieve their benchmarks as at April 30th, 2016, will be required to pay back their borrowings in full in September 2016.

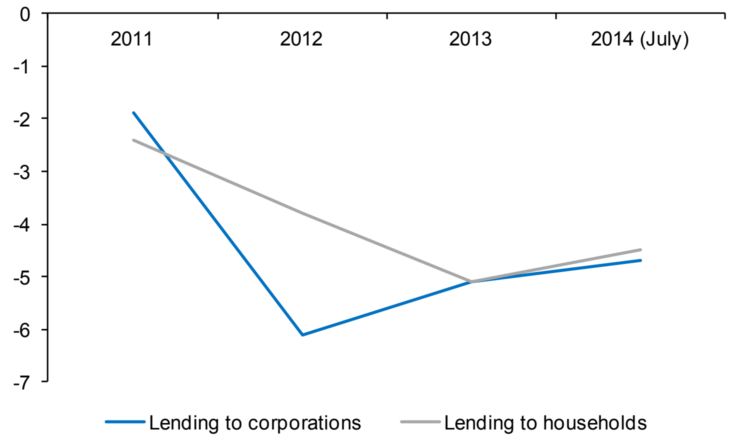
The initial operations were conducted on September 18th. The total allocation in the entire euro area was 82.6 billion euros. Spanish banks tapped 15 billion euros in this first TLTRO. This was 18% of the total allocation. It was less than expected by most analysts, but the demand is also expected to be larger in the coming rounds. The main reason is that the regulatory pressure from the stress tests and AQR may have conditioned the demand in the first round, but both will be completed by the time the second round is undertaken. Another reason is that the details of the ECB´s upcoming asset purchase program are yet to be announced and banks may be waiting to know them before defining their liquidity strategies.

The second TLTRO will take place on December 11th, 2014. The additional TLTROs will be carried out in March, June, September and December 2015 and in March and June 2016.

The TLTRO should help Spanish banks to change from negative lending rates to positive ones and to

Exhibit 3

Financing to the private sector in Spain. Annual growth rates



Source: Bank of Spain and own elaboration.

consolidate the recovery of the financing of the real economy by 2015. As for the projected outcomes, a positive feature is the particularly convenient way in which banks can access the targeted ECB liquidity. On the negative side, risks are still high and solvent demand is still scarce, in particular in a country like Spain with high and persistent unemployment levels. Up to now, the only relative progress made in financing to the private sector in the country has been to progressively achieve less negative annual growth rates (see Exhibit 3) although loan growth was still in negative territory by July 2014, the latest figures available.

Monetary policy decisions and the asset purchase program: Opportunities for Spanish banks

Further relevant decisions were adopted by the ECB on September 4th, 2014, with potential significant consequences for bank lending. The Governing Council decided to lower the interest rate on the main refinancing operations of the Eurosystem by 10 basis points to 0.05% and the rate on the marginal lending facility by 10 basis points to 0.30%. The rate on the deposit facility was lowered by 10 basis points to -0.20%. These are relevant measures since they make access to liquidity even cheaper and since the even more negative rate applied to the deposit facility may contribute to re-establish interbank markets.

In addition, the Governing Council decided to start purchasing non-financial private sector assets. In particular, the ECB note mentions the "purchase of a broad portfolio of simple and transparent asset-backed securities (ABSs) with underlying assets consisting of claims against the euro area non-financial private sector under an ABS purchase programme (ABSPP). This reflects the role of the ABS market in facilitating new credit flows to the economy and follows the intensification of preparatory work on this matter, as decided by the Governing Council in June. In parallel, the Eurosystem will also purchase a broad portfolio of euro-denominated covered bonds issued by MFIs domiciled in the euro area under a new covered bond purchase programme (CBPP3)."

The asset purchase program will start in October 2014 and the main details are still to be revealed. On the positive side, expectations for the program have improved since the inclusion of residential mortgage-backed securities (RMBS) will make this program potentially larger. As shown in Table 2, Spain concentrates 13.81% of the

Table 2

Securitization in European markets
Outstanding values (billion Euro) as of 2014Q1

	ABS	CDO	CMBS	RMBS	SME
France	19.5	0.0	2.0	9.7	1.7
Germany	36.3	1.8	9.5	14.8	3.0
Italy	47.7	1.7	10.1	81.5	27.7
Netherlands	2.6	0.7	2.5	248.4	7.6
Spain	24.1	0.5	0.3	115.3	29.0
United Kingdom	34.1	12.5	57.6	231.9	5.9
European total	190.4	126.4	95.9	834.5	108.2

Source: The Association for Financial Markets in Europe (AFME) and own elaboration.

outstanding amounts issued in the European RMBS market although this does not mean that all the issuances are allocated among Spanish counterparts. In any event, the size of the RMBS market is large enough as to make the effect of the program significant. On the negative side, however, what the program lacks –and the ECB itself acknowledges it– is a risk-sharing option that distributes the risk of acquiring the securities between the ECB and the national governments.

On the positive side, expectations for the asset purchase program have improved, since the inclusion of residential mortgage-backed securities (RMBS) will potentially make this program larger and the effect more significant. On the negative side, the program lacks a risk-sharing option that distributes the risk of acquiring the securities between the ECB and the national governments.

Overall assessment

Overall, it seems that all the policy objectives that the ECB is trying to achieve at the same time are compatible but it is uncertain that the transmission mechanism could effectively stimulate lending as much as it has been estimated. The main limitation is demand. In order to solve such a limitation, it would be necessary to set a risk-sharing mechanism between the ECB, the banks and the fiscal authorities in each euro area country.

In any event, a significant effect can also be expected from these monetary policy actions. Different private estimations point at Spanish banks borrowing between 30 and 50 billion euros with the TLTROs. If a high percentage of this borrowing is effectively transmitted to the real economy, the effect should be significant over the next two years but it is still too early to estimate such a long-term effect. As for the asset purchase program, it is still early to say to what extent the mechanism will have a significant impact as the technical details (which were not yet available at the time this article was written) will be very relevant.

SEFO - Spanish Economic and Financial Outlook Vol. 3, N.º 5 (September 2014)