The Eurozone´s new single bank supervisor: Perspectives from Spain

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The Spanish banking sector has performed quite favorably on the latest ECB comprehensive assessment, both in absolute terms, as well as relative to the EU average. These results suggest that the financial assistance programme for Spanish banks has had a considerably positive impact on the resilience of the financial sector, generating a comparative advantage.

On November 4th, the ECB became the single bank supervisor in the Eurozone. A comprehensive assessment of banks' balance sheets has preceded this historical event. Some basic comparisons on the overall results of the ECB assessment seem quite favorable for Spanish banks –of the 15 Spanish banks subject to the assessment, 14 passed without any observations. The overall impact of the combination of the asset–quality–review (AQR) and the stress-test under the adverse scenario results in just a 1.6% correction on average in the solvency ratio CET1, compared with 3.5% for the average bank examined in the exercise. Probably, the most significant positive impact for Spanish banks comes from AQR results, supporting the idea that the provisioning, recapitalization and transparency–enhancing measures implemented in Spain have been effective. In any event, profitability remains the main challenge for Eurozone banks. Financial intermediaries are still suffering value corrections in stock markets, mainly due to low profitability expectations. Given the regulatory pressures that banks face and the macroeconomic uncertainty, it will be difficult to restore credit growth in the short-term, although the upcoming liquidity programs of the ECB may have a positive impact.

Post-programme surveillance and the new supervisor

Spain represents quite a unique case in the banking crisis in Europe as regards restructuring and resolution tools. First of all, because there have been a number of countries which have been bailed-out, but in the case of Spain, the intervention was focused on the banking sector. Secondly, Spain is the country where the restructuring of the sector has been substantial both before and during the EU assistance program for the financial sector. These features, of course, imply several costs and sacrifices for the country but, at the same time, they facilitate a better matching of the supply and demand for financial services. This matching is commonly acknowledged as one of the most urgent efforts outstanding in many other European countries. However, many EU members

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in need of bank restructuring have been able to "hide" those restructuring needs because the macroeconomic conditions have been relatively favorable for them.

In this heterogeneous financial environment, there is a major transformation going on in the regulatory and supervisory structure of the banking sectors in the EU –the banking union. And a major historical precursor has taken place this month, with the European Central Bank assuming its role as single supervisor as of November 4th, 2014. Two weeks before that event, on October 26th, a comprehensive assessment of the Eurozone banking sectors was conducted by the ECB in coordination with the European Banking Authority (EBA). This exercise was conceived as a first serious check on the health of the banks under the Single Supervision Mechanism (SSM), just before the ECB took control.

Given that the Spanish banking sector has been subject to a strict restructuring and recapitalization programme under EU financial assistance, it was expected that Spanish banks could pass this comprehensive assessment without major problems. This article demonstrates that this was indeed the case.

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Paradoxically, even if Spanish banks have proven to have relatively good solvency conditions compared to other EU peers, post-programme surveillance by the European Commission and the ECB is still part of the conditionality imposed on the country for the financial aid received. The last post-programme mission was during October 6th-10th. Several aspects were examined including the macroeconomic situation, progress on structural reforms, and, of course financial sector developments. As for the economic conditions, the ECB and EC suggested that economic recovery had gathered momentum during 2014, with GDP growing at a faster pace than the euro area average. They highlighted the larger contribution of domestic demand, although they also observed that the external balance had weakened substantially since exports were less vigorous and imports were growing faster. Various factors were identified as drivers of higher internal demand including growing confidence, employment creation, easier financing conditions and low inflation. Amongst the main challenges for the economy, the deleveraging in the private sector was underlined (as in previous occasions) as a challenging, but necessary trend. Improvements in employment were also recognized although the unemployment rate was (and is) still very high. It should be noted that this analysis was conducted in a moment in which the prospects for the European economy were changing with countries such as Germany or France showing signs of weakness.

Attention is also paid to fiscal consolidation and public debt, since these factors have been closely linked to financial stability, in particular, after the sovereign debt crisis two years ago. The ECB-EC expressed their concern on the increasing public sector debt, although they value positively the possibility that this debt should peek in 2015, "if budget deficit targets for the coming years are met."

As for structural reform, some progress is identified, although considered to be "uneven." Some recent initiatives were viewed as particularly positive, including the revision of the corporate insolvency framework to facilitate corporate debt restructuring. Long overdue reforms, the implementation of the market unity law and the public administration reform, were also considered as advancements, with substantial room for implementation. The recommendations on the reforms front included some action to reduce the high degree of labor market duality.

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Finally, as regards financial developments –which constitute the main purpose of the surveillance analysis– the ECB-EC observe that market indicators of systemic risk in the financial sector continued to improve "reflecting positive trends in global financial markets" (which have now turned a bit more uncertain). For the banking sector in particular, an improvement of the liquidity situation is observed with Spanish banks increasing profits, improving efficiency and reducing impairment costs, which "more than offset the drag on revenues from shrinking credit volumes." A key observation ahead of the stress tests was that "banks' capital levels have been raised further and the stabilization in asset quality has started to be reflected in a marginal decline in the non-performing loans ratio at the system level."

Litigation costs at banks were still considered as a source of concern. Additionally, although the sale of NCG Banco to Banesco Group, Catalunya Banc to BBVA, and the sale of 7.5% of the government's stake in Bankia were considered as significant steps forward in the privatization of publicly-owned banks, much more progress on this front is expected to be achieved. Besides, some urgent measures, such as the implementation of savings bank reform, were also mentioned.

Finally, as for other European banking sectors, a big challenge is on profit generation, In particular, the surveillance report suggests that "for banks, the main challenge going forward appears to be the pressure on their profits from falling volumes of intermediation. The maintenance of adequate provisioning levels and capital buffers will be essential in this respect. SAREB's challenge of divesting its significant asset portfolio while maximizing value also remains significant."

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The environment described in the surveillance report is a good summary of the conditions that the Spanish banking sector was facing days before the comprehensive assessment of the ECB was implemented (the results of which we describe in the next section). In a way, this assessment can be considered as a warm-up to a tremendously significant event, the assumption of the single supervisor role by the ECB, which took place on November 4th. Even so, it should be noted that the Single Supervisory Mechanism (SSM) combines the actions of the ECB with some degree of decentralization towards national competent authorities. The ECB now directly supervises 120 significant banking groups, which represent 82% of the assets of the euro area banking sector. Importantly –as this is frequently neglected– for all the other 3,500 banks, the ECB will also set and monitor the supervisory standards and work closely with the national competent authorities in the supervision of these banks.

What was the performance and solvency situation of the European banking sector ahead of these tests? A useful tool for this analysis is the Report on Banking Structures (October 2014 edition) published by the ECB itself.[3] Some interesting findings in this document are as follows:

- Consolidation of the sector and rationalization (mergers, branch closing and, asset sales) continued. The total number of credit institutions decreased further to 5,948 in 2013, down from 6,100 in 2012 and 6,690 in 2008.

- Financial performance and profitability "remain subdued – though banking sectors in all countries avoided an operating loss."

- Improvements are found in the funding mix, as banks are observed to be less dependent on wholesale funding and more on customer deposits. Banks are observed to have been reducing their reliance on central bank funding, mainly reflected by repayments of LTRO funds.

- As mentioned before, profitability remains the main challenge. Importantly, this is not only the result of the low interest rate environment –and the related pressure on margins– but also of the "continuing deterioration in asset quality, and in some cases by restructuring and litigation costs."

The comprehensive assessment: Some comparative results

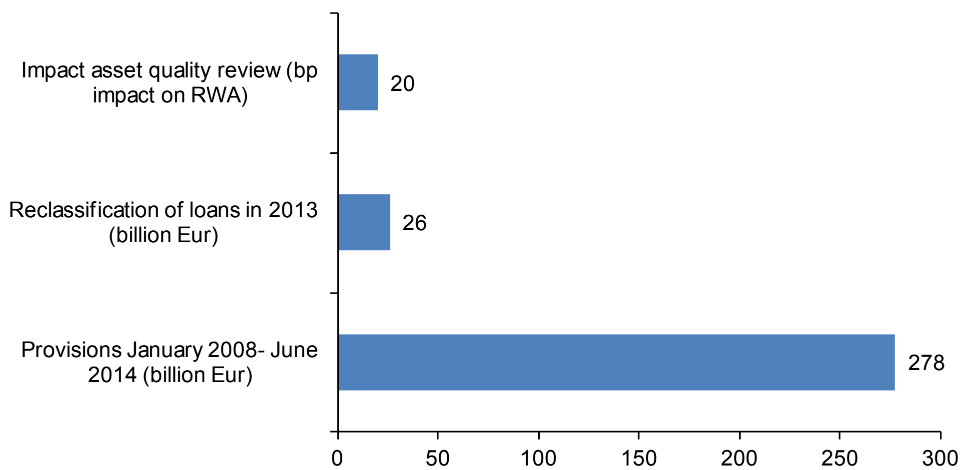
The results of the ECB comprehensive assessment were presented on October 26th. The exercise had two parts:

- An Asset Quality Review (AQR): this is mainly a data quality review involving asset valuation, classification of exposures (performing/non-performing), valuation of collateral and provisions, and impact on capital of incidents detected. After the necessary corrections due to the AQR, the common equity Tier 1 capital ratio (CET1) is expected to remain at least at 8%.

- A stress test: which is basically a forward-looking analysis of the banks' loss-absorption capacity under two scenarios (baseline and adverse). In this case, the projection of capital

Exhibit 1

The starting point for Spanish banks: A strong previous effort



Source: Bank of Spain and own elaboration.

[3] https://www.ecb.europa.eu/pub/pdf/other/bankingstructuresreport201410.en.pdf

ratios is made in both scenarios from 2014 to 2016. A CET1 of 8% is required in the baseline scenario and of 5.5% in the adverse scenario.

The main result of the joint assessment was a gross capital shortfall of 24.6 billion euros – 9.5 billion euros net, after considering the capital augmentations during 2014. Of the 25 banks that had a gross capital shortfall, 12 increased capital sufficiently during 2014, so that now there are only 13 banks with a net capital shortfall.

The exercises were applied to 130 banks from 18 euro area countries plus Lithuania. These banks represent 81.6% of total risk-weighted assets in the euro area. Spain is the second country in terms of the number of banks included in the exercise (15), together with Italy (15 as well).

The main result of the joint implementation of the AQR and the tests was a capital shortfall of 24.6 billion euros (gross, without considering any correction already undertaken during 2014) and 9.5 billion euros (net, after considering the capital augmentations during 2014). Importantly, out of the 130 banks, 25 had a gross capital shortfall in relation to one or more of the thresholds (AQR, baseline scenario and adverse scenario). Of these 25 banks, 12 increased capital sufficiently during 2014 so that now there are only 13 banks with a net capital shortfall.

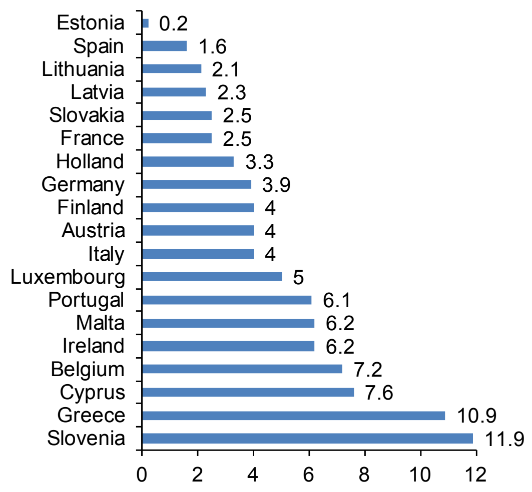
In Spain, only Liberbank has a small gross capital shortfall in the AQR exercise of 32 million euros, although the bank augmented capital for 637 million euros in 2014, thereby covering the gap.

There are some quantitative and qualitative positive outcomes of the comprehensive assessment for Spanish banks. First of all, they show that the financial assistance programme for Spanish banks had a considerably positive impact on the resilience of the banks. Moreover, as shown in Exhibit 1, the financial stability improvements in the Spanish banking sector are not just the result of EU financial aid. The provisions required on the banks both before and after the aid program have been substantial. In particular, Spanish financial institutions have devoted 278 billion euros to provisions from January 2008 to June 2014. By 2013, much of the provisioning effort had been made as Spanish banks "only" set aside 26 billion euros. All this helps to explain that the AQR of the ECB assessment just implied a correction of 20 basis points in the risk-weighted assets (RWAs) of the Spanish banks.

Secondly, some basic comparisons on the overall results of the ECB assessment seem quite favorable for Spanish banks. For example, of the 15 Spanish banks subject to the assessment, 14 passed without any observations. The overall impact of the combination of the AQR and the stress-test under the adverse scenario results in just an average 1.6% correction in the CET1, compared with 3.5% for the average bank examined in the exercise (Exhibit 2). The gap was 3.9% in Germany, 4% in Italy, 6.1% in Portugal, and 6.2% in Ireland.

Exhibit 2

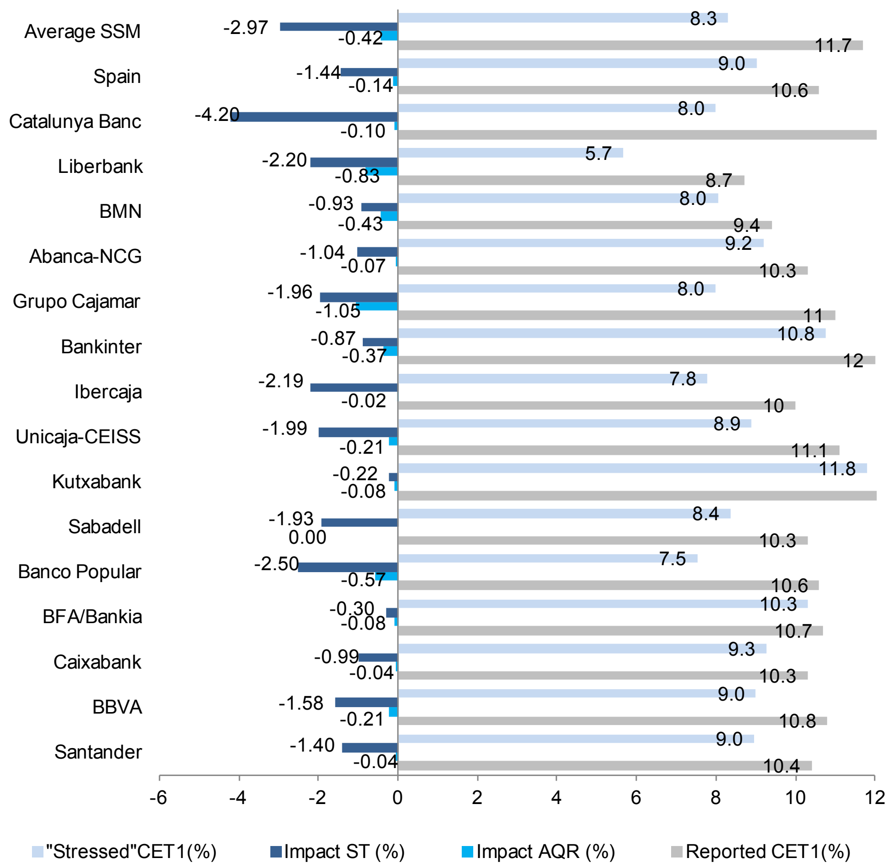
Main results: Impact of the stress test and the AQR on Common Equity Tier 1 (CET1)



Source: Bank of Spain and own elaboration.

Exhibit 3

Reported solvency and “stressed” solvency are quite in line



Source: Bank of Spain and own elaboration.

In any event, one of the most common mistakes in the analysis of the ECB assessment is to make rankings based on their outcomes. For example, the AQR is a detailed analysis of the balance sheets at year-end 2013 to verify that they give a realistic and fair view of these accounts. This should imply some adjustment due to differences in accounting practices across Europe. As for the stress tests, one of the key features is that the scenarios used differ from country to country and this makes comparisons even more complex. This makes the results of the Spanish case particularly valuable, as the adverse scenario conditions were comparably more severe for Spain.

Exhibit 3 shows the detailed results for Spanish financial institutions. It depicts step-by-step the correction in the CET1 ratios for each bank after passing the filter of the AQR and the adverse scenario in the tests. In a way, this is equivalent to a comparison of reported vs. “stressed” solvency. This is interesting in the Spanish case because most analyses of the sector over the last two years have shown that Spanish banks were still making an effort to converge to the average solvency levels of their European peers. However, after the stress tests, the “filtered” solvency of the Spanish institutions improves to a large extent above their European counterparts. As a result, convergence in solvency ratios has accelerated.

Ten reflections for the Spanish and the European banking sector after the assessment

In conclusion, there are, at least, ten relevant reflections on the situation of the Spanish banks after the stress tests:

- First of all, doubts on the solvency of European banks have been reduced to some extent. Nevertheless, concerns will remain over some of the sectors that have less resilience to the assessment, and, in particular, over Italian banks, as 9 of them were amongst those that failed. Deterioration still advances in Italy as the NPL ratio is growing by around 1% per quarter.

- Probably the most significant positive impact for Spanish banks comes from the AQR results. Accounting corrections for the review of assets are minimal and this supports the idea that the provisioning, recapitalization and transparency-enhancing measure implemented in Spain have been effective.

- The ARQ is a game changer, as it has implied a correction in several portfolios of European banks whose accountability was doubtful for investors. Importantly, given that some of the AQR criteria will prevail, this may also imply further correction in some banks –in countries like Germany, Italy or France– over 2014.

- It is important to keep a close watch on macroeconomic conditions. An increase in uncertainty is observed in the Eurozone economic recovery process. The adverse scenario in the stress tests is unlikely to happen, but the current probability of occurrence is not as small as it was when the scenarios were designed.

- German banks will be closely followed in the next few months. Even if only one German bank has failed the tests, many of the most relevant intermediaries have passed by only a small margin.

- Banks should be ready to communicate and to react to further examination of the detailed data published with the tests. Wrong or distorted interpretations of these data by observers can cause damage in the market value of the franchise.

- Elaborating rankings from the tests would be misleading. Results are based on different macroeconomic scenarios and assumptions for each bank and the current solvency levels may be the result of different combinations of capital improvements, from profit generation to State aid.

- Profitability is still the main challenge for the banks in the Eurozone. Profits are also under stress, but the assessment put an emphasis on solvency.

- Overall, European banks are still suffering value corrections in stock markets. Low profitability expectations are one of the main explanations.

- It will be difficult to restore credit growth in the short-term, although the upcoming programs of the ECB may have a positive impact. The announced withdrawal of monetary stimulus from the Fed is a major issue in international financial markets. These markets –in particular, the European banks– are not yet ready to substitute “official” liquidity by private liquidity and the ECB will have to make a significant effort beyond the comprehensive assessment to revitalize banking activity in the Eurozone.