# Redesigning the Spanish banking sector in 2015: Reactivating business and boosting profitability

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**Greater transparency and improved solvency have brought renewed confidence in the Spanish banking industry. In 2015, a more favorable economic outlook and post-restructuring improvements will allow Spanish banks to increase private sector lending, as well as face profitability challenges also common to most of their international peers.**

*2014 was a transition year for Spanish banks. After the EU financial assistance program, post-surveillance reports have shown that restructuring and recapitalization efforts have made Spanish banks more resilient. The efforts of the banking sector mirror to some extent those made by the private sector, as banks have reduced their assets by nearly 280 billion euros since 2008. They have also reduced their reliance on the ECB, in part due to more funding from customer deposits. Additionally, initiatives to boost transparency and the comprehensive assessment conducted by the ECB have revealed that Spanish banks have improved their regulatory capital ratios (CET1) to 11.6% - exceeding regulatory requirements. After years of transformation, these advances –together with better economic expectations– will result in an increase in lending rates to the private sector in 2015 and have put Spanish banks in a competitive position to address the profitability challenge facing most international banks in 2015.*





## Post-surveillance challenges

2014 was a transition period for the Spanish banking sector. Most of the measures imposed on Spanish banks receiving aid within the EU financial assistance program were completed as planned by mid-2013. However, some of them involved long-term tasks and EU surveillance. These long-term tasks developed as expected during 2014, as stated in the various post-surveillance reports published by the European Central Bank, the European Commission and the International Monetary Fund (the main contents of these reports have been discussed in earlier editions of *SEFO)*.

Two specific advances in long-term commitments were observed during 2014:

- Privatization of some of the nationalized banks.
- Progress on the sale of impaired assets transferred by the banks receiving aid to the asset management company SAREB.

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The privatization process has advanced slowly, as it requires case-by-case treatment, as well as the necessary market conditions for the allocation of shares. Nevertheless, there were two successful initiatives during 2014: i) the partial public allocation of a stake of the Fund for the Orderly Restructuring of Banks (FROB) in Bankia; and, ii) the acquisition of Catalunya Banc by BBVA.

The privatization of Bankia should continue to progress during 2015 although some litigation risks have emerged. A court investigation into the flotation and bailout of Bankia may potentially imply a compensation to IPO participants, although this risk is said to be under control. Whatever the outcome of the legal process, Bankia has confirmed its intention of completing the restructuring agreed upon with EU authorities in 2014 – two years ahead of schedule. The bank also intends to resume dividend payments.







As for Sareb, even if it is still a bit soon to evaluate its progress, during 2014, there has been a perceptible acceleration of asset sales and some relevant management decisions, such as the transfer of the sale mandate to various private firms, a decision that aims at making the allocation of assets more efficient.

As of the final stages of last year, Sareb has sold portfolios valued at 847 million euros. The asset management company sold the so-called Agatha portfolio, including 38 performing loans with a par value of 194 million euros and 10 rented housing developments valued at 65 million euros. The company has also completed the sale of the Olivia portfolio, comprised of seven performing loans with a par value of 140 million euros. The sale of project Kaplan was also near completion, including performing and non-performing loans linked to small and medium-sized developers, with a par value of 234 million euros. The sale of an additional loan portfolio with a par value of 133 million euros was also closed.

In addition to the previous transactions, the sale of four office buildings was also completed with a value of 81 million euros.

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It is also worth mentioning that the reforms to come in 2015 include regulatory initiatives, such as the completion of the reform of the savings banks sector. The draft circular by the Bank of Spain on savings banks and banking foundations is now in the consultation process and should be approved in the near future.

Additionally, the transposition of the Banking Recovery and Resolution Directive and Deposit Guarantee Directive will also be major challenges in 2015 and a significant step in the construction of the banking union.

## Accelerating deleveraging of private debt should avoid the need for restructuring

Given that private sector debt increased substantially in the years prior to the crisis, deleveraging efforts have been identified as one of the major, but necessary, sacrifices in the recovery process of the Spanish economy. When a country faces a challenge to reduce its debt, there is always a debate on whether a restructuring of such debt is necessary. Actually, this debate is still present and Spain is among

the countries where different opinions emerge about how to proceed. However, the data seems to suggest that Spanish households and firms are rapidly deleveraging over the last two years. The information provided by the Bank of Spain on the *Financial Accounts* of the private sector shows that total private debt increased from 197.2% in 2006 to 216.9% in 2010. It remained over 200% of GDP until 2012, but it had fallen to 182.1% in 2014Q2. This implies a debt reduction of 429,684 million euros from 2010 to 2014Q2. This transition suggests that private debt restructuring is not necessary in Spain as deleveraging looks feasible and the reputational and financial problems related to debt restructuring can be avoided.

Deleveraging of the private sector is also being mirrored by the banking industry. The total assets of Spanish banks have decreased from 3.22 trillion euros in 2008 to 2.94 trillion euros in October 2014 (a 9.5% fall). The squeeze in bank assets is common to most EU banking sectors and is a natural consequence of the necessary matching between demand and supply in a post-crisis environment. This change has been significant in Spain, as restructuring has been more pronounced that in other EU countries whose financial sectors are still in need of structural changes.

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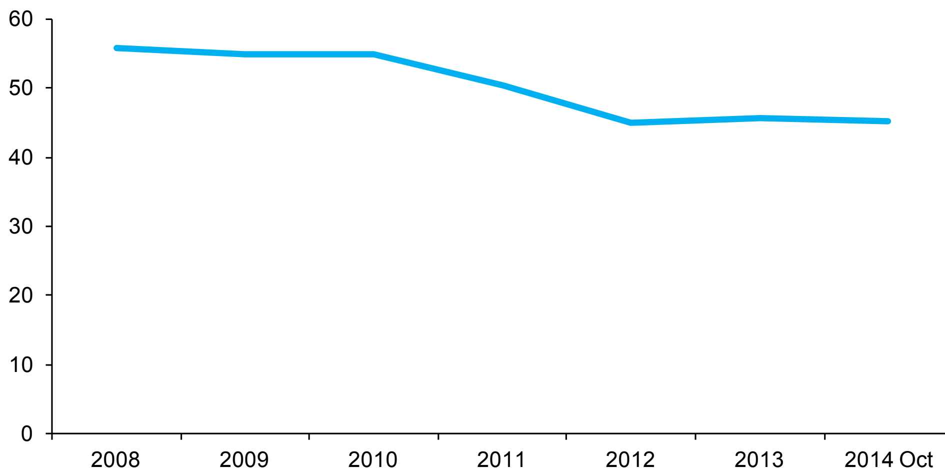
## Lending environment

A natural outcome following the redesign of a banking sector after a severe crisis is the improvement of credit conditions. 2014 seems also an inflection point for credit for two reasons: i) supply factors have improved as banks have completed the bulk of the projected restructuring and recapitalization efforts (as certified in the recent ECB comprehensive assessment); and, ii) demand conditions are also

Exhibit 1

**Loans to total assets in the Spanish banking sector (2008-2014)**

**(Percentage)**




*Source: Bank of Spain and own elaboration.*

improving as the projections for 2015 point to a GDP growth of 2% or even higher.

Loans as a proportion of total bank assets have been falling in recent years in favor of other assets such as public debt. In particular, loans have decreased from 55.7% in 2008 to 44.9% in 2012. The ratio has then stabilized at around 45% (Exhibit 1).

The flow of funds data provided by the Bank of Spain reveal that annual lending rates were still in negative territory in 2014, but the rates are progressively recovering and the expectation is that lending growth will be positive (although moderate) in Spain in 2015, thereby accompanying economic growth.

Importantly, there is a change in the composition of loans to firms that is already perceptible in 2014 with a higher proportion of loans being granted to small-and-medium enterprises (SMEs). As reported by the Bank of Spain in the November edition of the *Financial Stability Report* (data as of June 2014), the volume of credit received by SMEs from Spanish deposit taking institutions amounted to 290 billion euros (21% of the total lending to the resident private sector, while the volume extended to large firms was 236 billion euros (18%). Within SMEs, 42.9% of the credit granted corresponds to medium-sized enterprises, 27.4% to small enterprises and the remaining 29.7% to microenterprises.

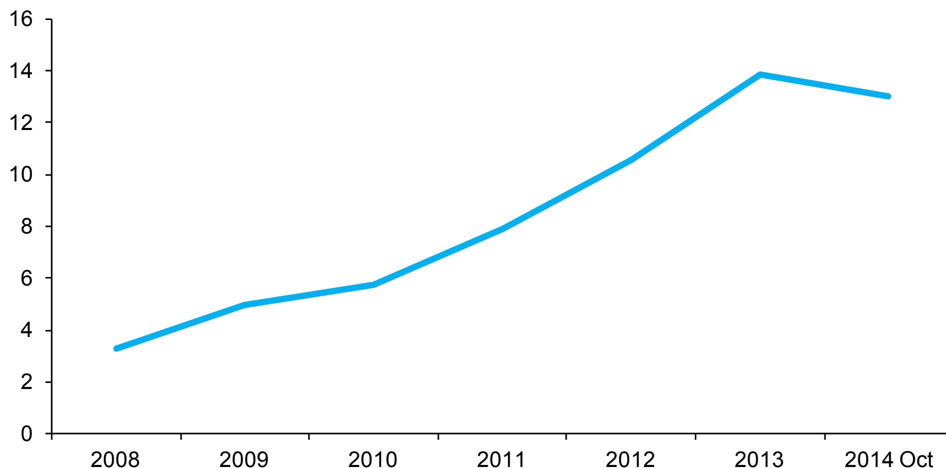
The improvement in the quality of loan portfolios will also have a positive impact on credit recovery. The non-performing loan ratio of Spanish banks increased to near 14% by 2013 and the latest data as of October 2014 show the NPL ratio has fallen to 13% and the expectation is that it will continue to go down as economic conditions improve (Exhibit 2).

Another indicator that suggests a recovery in lending in 2015 is the participation of Spanish banks in the targeted long-term refinancing operations (TLTRO) program of the ECB. By combining the two first TLTROs in September and December 2014, the estimations suggest Spanish banks have tapped 37.5 billion euros, around 17% of total funds demanded by Eurozone

Exhibit 2

**Non-performing loan ratio in the Spanish banking sector (2008-2014)**

**(Percentage)**



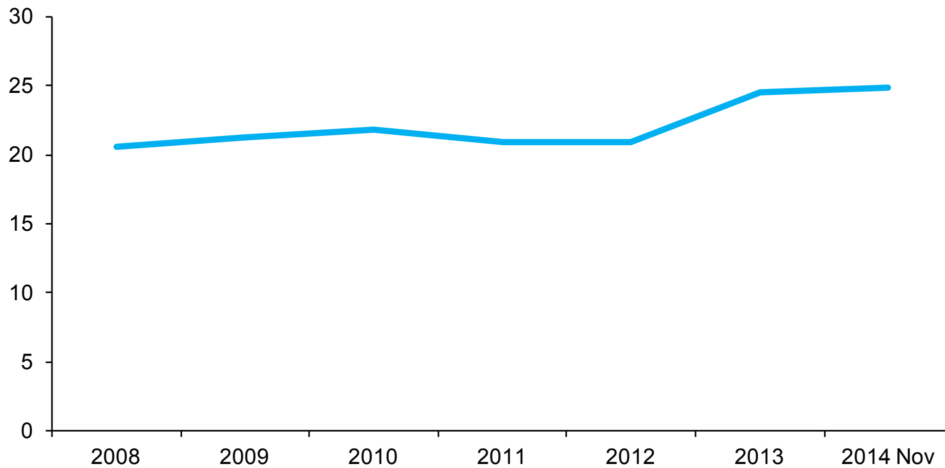

*Source: Bank of Spain and own elaboration.*

banks. Whether or not this liquidity will finally be channeled to new loans in 2015 will depend on the confirmation of improved economic prospects, but overall this appears to be a positive sign.

Exhibit 3

**Deposits to total assets in the Spanish banking sector (2008-2014)**

**(Percentage)**

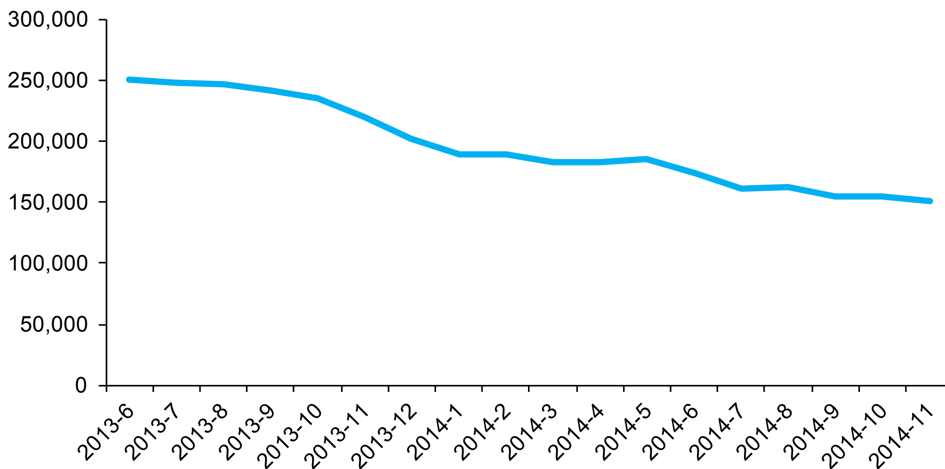



*Source: Bank of Spain and own elaboration.*

Exhibit 4

**Net borrowing from the ECB by Spanish banks (2013-2014)**

**(Million euros)**




*Source: Bank of Spain and own elaboration.*

## Improvement in funding sources

There is also evidence of better access to funding by banks. One indication of the improvement in liquidity and customer-based funding is the growth in deposits in the liability side of banks' balance sheets. Deposits over total liabilities have remained around 20-21% during 2008-2012. However, the ratio has increased to 24.5% in 2013 and to 24.8% in November 2014 (Exhibit 3).

In any event, perhaps the most obvious improvement in the funding conditions of Spanish banks is the significantly smaller reliance on ECB funding. Borrowing from the ECB by Spanish banks fell from 250 billion in June 2013 to 150 billion in November 2014 (Exhibit 4).

## Better and more transparent solvency

At the beginning of 2014, many analysts considered that Spanish banks were still lagging behind their European peers in terms of solvency, even if most of the recapitalization efforts under the EU assistance program were already made. Interestingly, the comprehensive assessment conducted by the ECB in October revealed that 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 Core Equity Tier 1 capital ratio (CET1) of Spanish banks, compared with 3.5% for the average bank examined in the exercise. This put Spanish banks much closer to the best practices in Europe in terms of solvency.

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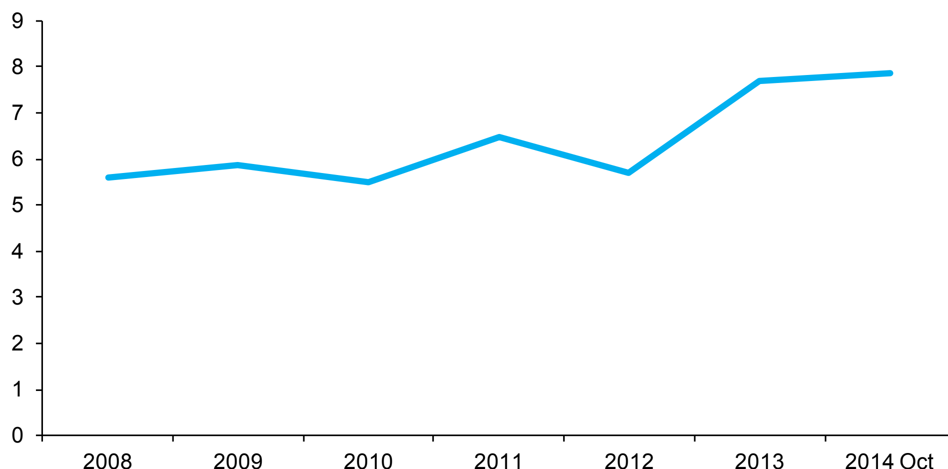
As shown in Exhibit 5, the total capital ratio (equity/ total assets) of Spanish financial institutions

Exhibit 5

**Equity to total assets at Spanish banks (2008-2014)**

**(Percentage)**




*Source: Bank of Spain and own elaboration.*

has substantially increased from 2012 (5.6%) to October 2014 (7.8%).

As noted in the *Financial Stability Report* (November edition) of the Bank of Spain, the CET1 ratio of Spanish banks in June 2014 was 11.6%, clearly exceeding the regulatory requirements.

A quantitatively and qualitatively relevant announcement on bank solvency in Spain was made on January 7th. Banco Santander announced the sale of shares for as much as 7.5 billion euros, a considerable capital augmentation that has implied some reduction in the share value in the short-term, but will ultimately strengthen the solvency of the bank in the long-run.

## Profitability: Time to consolidate the recovery and find new sources

Even after improvements in restructuring and recapitalization, profitability remains a major challenge for Spanish banks as well as for their European peers. A first important achievement –and almost a natural consequence of the efforts made– is the return to positive profits. This occurred in 2014, even though the pressure on bank margins was still significant (Exhibit 6).

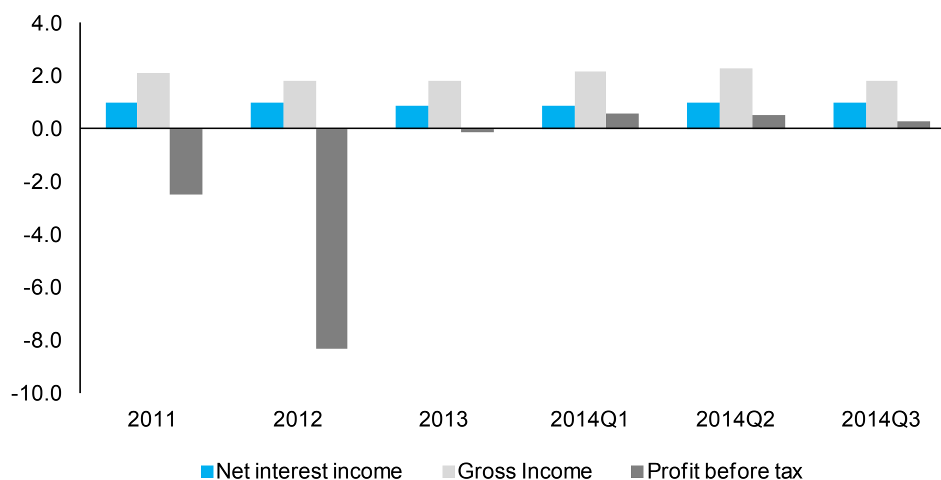
Some of the profits were coming from extraordinary transactions (such as asset sales) but banks are also making efficiency efforts to face the downward trends in revenues. For example, the interest margin over total assets of Spanish banks was 1% in 2011 and also 1% as of 2014Q3. However, interest revenues were 2.8% in 2011 and only 2% in 2014Q3. Hence, banks have managed to reduce interest expenses from 1.8% to 1% in the same period.

Profitability of Spanish banks is again a competitive advantage. The latest data provided by the European Central Bank (released in November 2014) corresponds to June 2014. Table 1 compares Spanish banks with five of the other largest European banking sectors. The Spanish competitors do not only exhibit a larger interest

Exhibit 6

**Evolution of profitability at Spanish banks (2011-2014)**

**(Percentage total assets)**




*Source: Bank of Spain and own elaboration.*

Table 1

**Comparative efficiency and profitability indicators at the largest EU banking sectors (June 2014)**

**(Percentage total assets)**

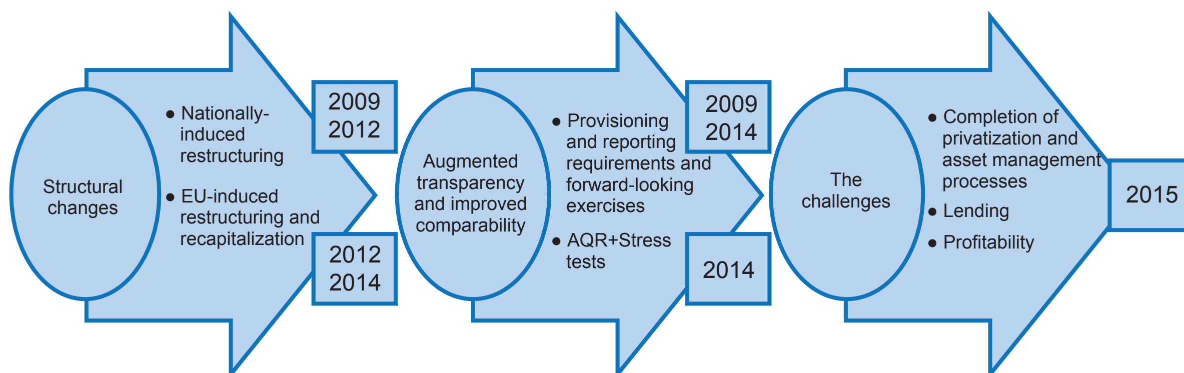
| | Germany | Spain | France | Italy | Netherlands | United Kingdom |
|---|---|---|---|---|---|---|
| *Income (% of total assets)* | | | | | | |
| Interest income | 2.23 | 3.28 | 2.3 | 2.77 | 3.89 | 1.71 |
| Net interest income | 0.8 | 1.78 | 1.06 | 1.49 | 1.28 | 1.01 |
| Total operating income | 1.58 | 2.95 | 2.14 | 3 | 1.74 | 1.93 |
| Expenditure structure (% of total assets) | | | | | | |
| (Total operating expenses) | -1.16 | -1.38 | -1.47 | -1.78 | -1.14 | -1.25 |
| Profitability (% of total assets) | | | | | | |
| Operating profits | 0.42 | 1.57 | 0.67 | 1.21 | 0.6 | 0.68 |
| (Provisions) | NA | -0.09 | 0 | -0.06 | 0 | -0.17 |
| (Impairment) | -0.08 | -0.85 | -0.4 | -0.8 | -0.25 | NA |
| (of which Impairment on financial assets not measured at fair value through profit or loss) | -0.08 | -0.8 | -0.38 | -0.79 | -0.26 | NA |
| Summary profitability and efficiency indicators | | | | | | |
| Cost-to-income ratio (%) | -73.26 | -46.85 | -68.76 | -59.49 | -65.38 | -64.77 |
| Return on equity (%) | 4.77 | 7.39 | 4.85 | 2.41 | 5.89 | 6.76 |
| Return on assets (%) | 0.21 | 0.52 | 0.26 | 0.17 | 0.29 | 0.39 |

*Sources: ECB and national central banks.*

and operating income but also a higher return-on-equity (7.39%) and return on assets (0.52%). These differences are explained, to a significant extent, by improvements in efficiency. The cost-to-income ratio remains below 50%, while in most of the other countries analyzed it is over 60%.

Exhibit 7

**The redesign of the Spanish banking sector**




*Source: Own elaboration.*

## Conclusion

Exhibit 7 summarizes the different factors that have led the Spanish banking sector to face new challenges in 2015. The structural changes over the last few years have put banks in a better competitive position both in terms of the matching of supply and demand as well as relative to other EU peers. As shown in the exhibit, this transformation has been the result of private and public nationally-induced reforms as well as EU-induced changes.

Greater transparency and improved solvency have brought renewed confidence in the Spanish banking industry. In 2015, the advances in the long-run commitments of the banking crisis resolution process (privatizations and troubled assets' management) will be developed in parallel to the recovery of lending and the search for new sources of profitability.