The Spanish banking sector in the financial turbulence of 2016

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

In the context of a difficult start to 2016, the Spanish banking sectors´ recent performance on profitability and solvency indicators has been positive and transparency has improved. As the outlook ahead remains equally complex, banks in Spain and in Europe will have to adopt transformational changes across key areas to remain competitive.

The markets got off to a somewhat turbulent start in 2016, with the European banking sector among the worst affected. Doubts have arisen about the quality of assets held by some of Germany's systemically important institutions, and countries, such as Italy, have had to take steps to address a spiralling default rate. Although the loss in value in early 2016 was spread across Europe, there have been some noteworthy positive developments for the Spanish banking sector. Spanish banks' profits have risen –the six largest Spanish banks increased their joint profits in 2015 by 8.1% relative to the previous year. Their solvency has improved – banks' fully-loaded core tier 1 capital (CET1) ratio rose from 10.9% in 2014 to 12.2% in 2015. Private sector credit growth is expected to return to positive figures in 2016. Finally, Spanish banks may benefit in the medium-term relative to their peers elsewhere thanks to the enhanced transparency exercises undertaken. The outlook remains challenging and both the European and Spanish banking sectors will have to adopt transformational changes across key areas to realign themselves with the new paradigm.

A difficult start to the year: Market and regulatory pressure

European financial markets got off to a fairly tough start this year and the banks were among the worst affected. Against this backdrop, other factors arose that were unfavourable to the sector's outlook, such as the threat of the United Kingdom's leaving the European Union, or doubts about the situation and solvency of certain financial institutions in Italy and Germany. In January alone, the European sector index for the continent's banks registered a loss of value of 350 billion euros.

The unique macroeconomic situation further complicated matters. While expansionary monetary policy has undoubtedly made it easier for banks to obtain liquidity, the sharp drop in interest rates –with some inter-bank rates even

[1] Bangor Business School and Funcas.

[2] University of Granada and Funcas.

turning negative– has put interest margins under intense pressure, heightening European banks' difficulties, although shared in part by banks elsewhere.

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In any event, as Benoît Cœuré, Member of the Executive Board of the European Central Bank, recently noted, interest rates are not the only challenge the banks are facing. Non-performing loans and the sector's lack of consolidation are the main factors creating uncertainty for the banks.[3]

Moreover, market volatility is a response to a series of factors beyond banking activity, including uncertainty over China and emerging markets and the upheaval in energy markets, with the slump in oil prices.

Doubts also persist as to the European economy's ability to take off in an environment in which monetary policy is running out of room to manoeuvre and there is little sign of any political will for coordinated expansionary policies. As regards the factors intrinsic to the banking market, the quality of some systemic European banks' balance sheets is still questionable, while in some countries, such as Italy, a new asset management company has even been created (a "bad bank"), given the aggregate scale of its non-performing loans.

The crisis also highlighted the existence of excess capacity in the European banking industry. Restructuring thus became the main mechanism for rebalancing supply and demand. However, these processes have been very uneven and in many countries there is still a lot to do. What is more, it has become apparent that the major bail-outs in 2008, not being accompanied by significant restructuring, have delayed many institutions' return to profitability, resulting in these institutions ended 2015 with significant losses. Some of these institutions now face significant adjustments to be realized through branch closures and staff cuts.

An additional factor significantly impacting market perceptions of European banks' is regulatory pressure. Regulatory pressure can only be expected to increase, given the supervisory shortcomings and inadequate solvency requirements uncovered during the financial crisis. However, the impact that these requirements may be having on the banking sector's capacity to increase credit flows and stimulate productive investment has perhaps not been sufficiently gauged. Although this issue deserves more thorough analysis – beyond the scope of this article – there is no doubt that the discussion of how strict regulatory requirements should be is back at the top of the agenda.

It is also worth asking to what extent the European Banking Union, in its current design, is functioning. On February 22nd, 2016, with the help of competent national authorities, the Single Resolution Mechanism (SRM) began to collect data with which to determine the minimum requirement for own funds and eligible liabilities (MREL). In order for the SRM to be able to draw up resolution plans for each entity, it needs to know about specific aspects of their solvency and leverage. These data are collected by means of exhaustive questionnaires. This is undoubtedly an important task, but the decentralisation and multiple layers of bureaucracy involved in the current banking union are such that regulatory compliance is absorbing a vital part of the banking sector's human resources. In recognition of this effort, the SRM's timetable for completing these questionnaires has been spread over 2016.

[3] Talk given at the "Süddeutsche Zeitung Finance Day 2016," Frankfurt am Main, March 2nd, 2016: https://www.ecb.europa.eu/press/key/date/2016/html/sp160302.en.html

In this context of decentralisation and a multiplication of regulatory requirements, the European Banking Authority (EBA) has also designed an EU-wide stress test exercise for 2016. It published the methodology for these tests on February 24th, 2016, and two points stand out. The first is that the EBA aims to publish the results in the first quarter of the year. The second is that, somewhat controversially, the EBA has said that it will not set a minimum capital requirement. On the one hand, it seems logical given that the EBA aims to gather information for this year's supervisory evaluation and review process (SREP), which is when decisions on capital levels will be made. But on the other hand, such an evaluation dilutes

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the essence of the stress tests and weakens their *ex-ante* and *ex-post* disciplinary character, particularly in comparison with other similar tests, such as those conducted in the United States. On the whole, they do not seem likely to help reduce current market uncertainty.

As regards regulation from Spain, on February 9th, 2016, the Governing Council of the Bank of Spain approved the circular on supervision and solvency, which completes the adaptation of the European rules deriving from the Basel III Accord. The Circular lays down the regulations for branch offices and the freedom of credit institutions based in non-EU countries to provide services in Spain, and it spells out the capital buffer requirements. It also includes various provisions on credit institutions' internal organisation and remuneration policies, along with the internal capital adequacy assessment process entities are to undertake, as well as covering other points, such as the rules on the transparency of credit institutions, and their reporting obligations to the Bank of Spain.

The Spanish banking sector: Results and expectations for credit

In the context of the situation described in the preceding section, the Spanish banks' year-end 2015 results (presented in February 2016) can be viewed as positive. Particularly when compared with the huge losses suffered by large institutions in the United Kingdom, Germany and Italy.

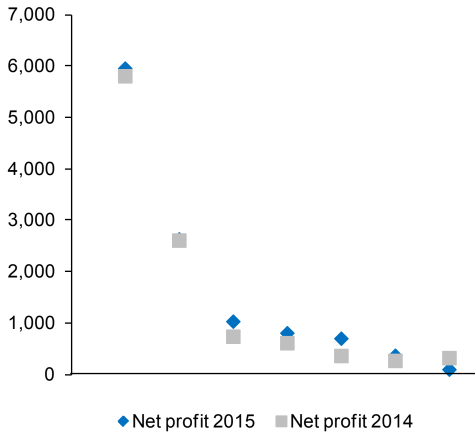
Exhibit 1 aims to give a single snapshot of the two main elements for market scrutiny: profitability and solvency. In the case of the former, the six largest Spanish banks increased their joint profits from10.8 billion euros in 2014 to 11.7 billion euros in 2015, an increase of 8.1%. The variability in the magnitude of the results is due to the differences obtained from extraordinary operations and the uneven impact of insolvency provisions. In particular, these were reduced sharply in 2015.

The second panel of Exhibit 1 shows how solvency has progressed, from a fully-loaded core tier 1 capital (CET1) ratio, which shows the highest quality capital the entity would currently be deemed to hold if it were obliged to meet today the Basel III regulations envisaged for 2019. Averaged across these six large banks, CET1 rose from 10.9% in 2014 to 12.2% in 2015. This is a significant increase. In general, a degree of confusion has arisen as to the extent to which it is advisable to raise the own funds ratio above the regulatory minimum. The academic literature has for a long time illustrated various aspects of the – entirely logical– existence of the opportunity cost of capital, namely that higher capital requirements mean less lending. In recent years, it has been said that Spanish financial institutions started out from lower solvency levels than their European counterparts, the reasons including the fact that some components of this capital in Spain, such

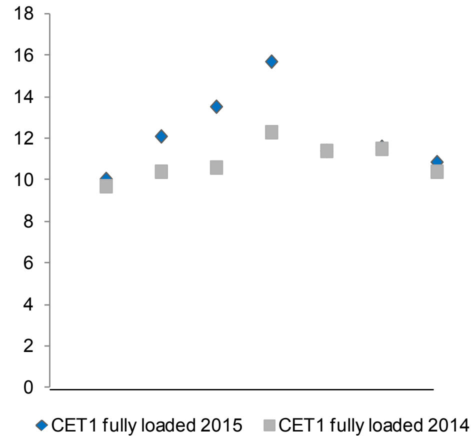
Exhibit 1

Profits and solvency of Spain's six largest financial institutions in 2014 and 2015

1a) Profitability (EUR million)



1b) Solvency (%)



Source: Financial institutions' consolidated accounts and authors' calculations.

as tax credits, would not be recognised as own funds by Basel III in 2019. Nevertheless, the banks have shown their capacity to increase other components of CET1. The "value" of the capital ratios also depends on the transparency of the assets in the denominator. If any European banking sector has really undergone an enhanced transparency exercise it is Spain's. This also reduces the uncertainty as to the value of the buffer between the demonstrated and minimum regulatory solvency.

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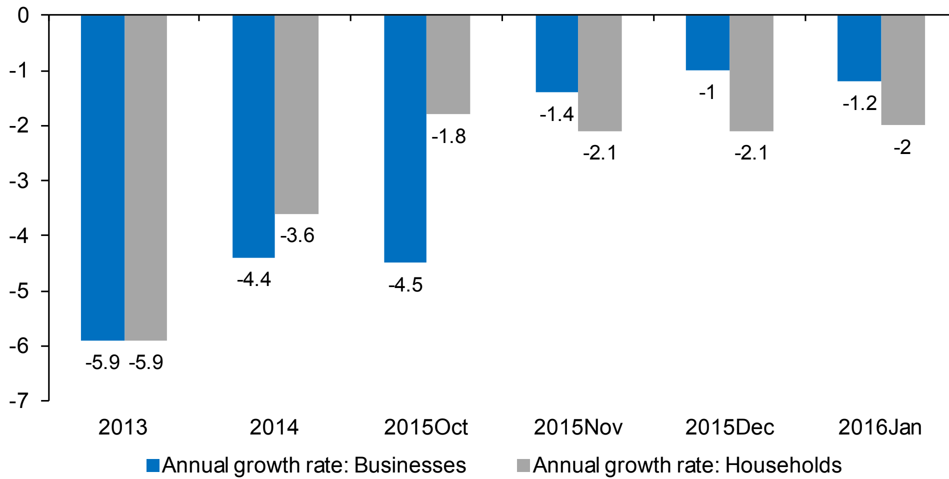
Specifically, as regards the progress of credit – and SEFO's monitoring of it – the most recently published data suggest that year-on-year rates of change in financing to the Spanish private sector remained negative in January 2016 (Exhibit 2). Positive rates of change are anticipated in 2016,

Exhibit 2

Year-on-year change in lending to the Spanish private sector



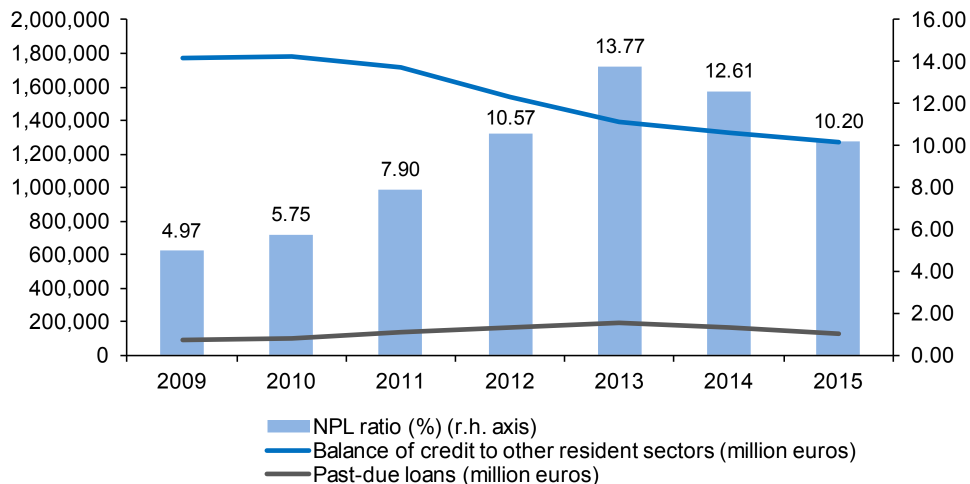
Source: Bank of Spain and the authors' calculations.

however, at around 3%, although this recovery is subject to the uncertainty deriving from the political deadlock and its actual and potential impact on investment projects.

The quality of the credit balance also continues to improve, as shown in Exhibit 3. The most recent data, from December 2015, show the ratio of doubtful credit to total private sector credit to have

Exhibit 3

Non-performing loans in Spain



Source: Bank of Spain and the authors' calculations.

fallen to 10.2% from a peak of 13.77% in 2013. As total credit increases (the ratio's denominator) and the balance of non-performing loans continues to decline (as has been observed in recent months), the drop in the ratio will accelerate.

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Fresh doubts about European banks?

Recent doubts have resurfaced over European financial stability. The problems were particularly acute in February, when concerns arose over Deutsche Bank's ability to meet its debt maturities. The systemic character of this German bank lies not only in its size but also in the fact that it holds derivatives worth over 50 trillion euros, 17 times Germany's GDP. This is not to say that these derivatives are putting the bank at risk, but that its leverage could potentially drag down a significant number of other European banks. The bank bought back part of its debt and brought payments forward to calm investors, but the doubts could resurface at any time, as since 2008 there has been a persistent problem of transparency affecting part of the European banking system's exposure to structured products.

Specifically, the doubts arising again now are related to the failed resolution framework existing in 2008, which has since been reformulated in the context of banking union. New European banking supervision and resolution mechanisms have been proposed, in which bondholders, as well as shareholders, are to face losses before taxpayers. What is more, bondholders cannot be paid a dividend if the bank has not made a profit. Deutsche Bank was the first entity to face this restriction on paying bond dividends, specifically affecting its CoCos (contingent convertible bonds). However, it is not the only European entity to have issued CoCos, and the market has consequently punished bank bonds, and ultimately, the shares into which they may be converted. This explained a large share of their loss of market capitalisation.

This uncertainty coincides with the undeniable evidence that inter-bank interest rates are falling to negative levels, putting even more pressure on banks' margins. Indeed, the catalyst for these fears was the Bank of Japan's decision to set negative official rates, although the banks were offering deposits with positive rates. This mismatch across jurisdictions gives rise both to regulatory arbitrage and disparity in bank securities on different markets.

The doubts have also spread to Italy's banks. The latest analysis suggests that Italy's irrecoverable debts amount to 200 billion euros, i.e. 16.7% of total credit, compared with 7% in Spain and 4% in France. Other Bank of Italy estimates suggest that there could be a further 160 billion euros of doubtful loans. Italy's authorities have responded by setting up an asset management company (or "bad bank"). However, somewhat surprisingly, this company remains under the control of the Italian supervisory body, without the involvement of the European SRM. This treatment is in sharp contrast with that seen in other jurisdictions, such as Spain.

Instead of cohesion on the subject of transparency, Europe appears to be caught up in a regulatory dispute that could even be considered "diversionary tactics." Thus, for example, Germany has repeatedly insistently that holdings of government debt on bank balance sheets should be penalised. One of the longer-term effects of repeated bouts of increased sovereign risk is that government bonds are no longer an instrument for coverage and balance sheet diversification,

but are marked with a degree of stigma. However, in reality, these exposures, which are more or

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Transformation under way

As a conclusion to the discussion of trends in European and Spanish banks, one might ask - what are the main lines of transformation for the Spanish banking system in 2016? These are summarised in Exhibit 4.

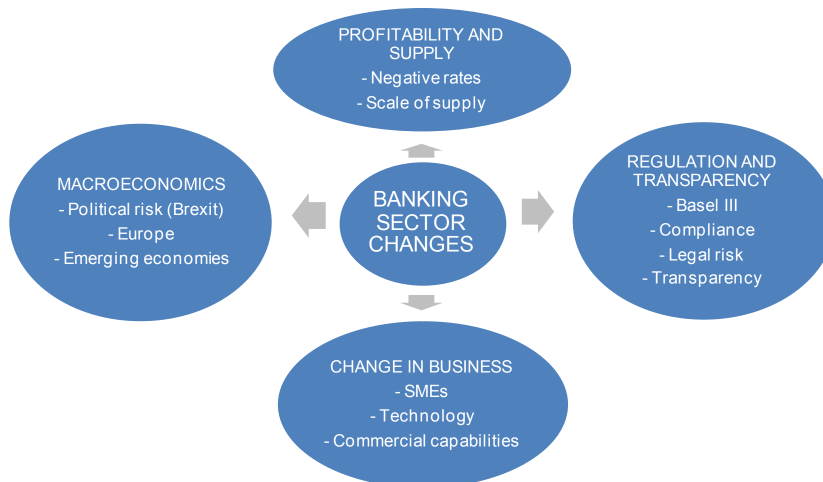
Firstly, banks continue to face the challenge of profitability, particularly in the current context of negative interest rates. There are those who argue that there are a number of reasons why these negative rates may have undesirable effects. First of all, with such low rates, there is little leeway for monetary policy and its impact on the market is diminished. Moreover, with high levels of public and private debt, it is difficult to envisage an easy path back to higher interest rates. The banks' need to make a profit rules out products and services based on negative rates, at least on a widespread basis, in the case of either deposits or credit.

When margins tighten, the response seems to lie in consolidation (*i.e.* competitors tend to merge so as to get a bigger share a smaller market "pie"). Significant progress has been made in this direction in Spain, but there is still a long way to go. In Europe, this is particularly fertile ground for corporate activity over the coming years.

The challenges of regulation and transparency are critical. Although the main aspects have been dealt with in previous sections of this note, it is worth highlighting that there are significant

Exhibit 4

Main lines of transformation for the banking sector in 2016



Source: Authors´ own elaboration.

differences in transparency (observable balance sheet quality) among European banks, and neither the Single Resolution Mechanism nor the planned stress tests seem able to solve this issue satisfactorily.

From the macroeconomic viewpoint, the weakness of certain emerging economies stands out. This could have a negative impact on some Spanish entities, but the long-term effect should be viewed as positive, as the recent historical perspective shows geographical diversification to have clear benefits. Political risks, and Brexit in particular, could also have impacts on the macroeconomic level. It should come as no surprise that the City of London's banks are strongly against the UK's leaving the EU. The gains from financial integration and interaction are clear, and any scenario of disintegration would have serious negative consequences.

Finally, there is the change in the banks' business. The unavoidable correction in the property sector has led many European banks to rethink their business and focus more on SMEs. This is a complex strategy, as it requires a change in the competences of banks' human capital – to take a more proactive approach and offer more tailored services – because this type of financing is particularly penalised by solvency regulations. Technology remains part of the answer, but there are a whole host of initiatives, and it is difficult to distinguish which will emerge victorious and what their true impact will be.