Miguel Fernández Ordóñez: Current status of the Spanish financial system

Speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, to the Council on Foreign Relations, New York, 11 March 2011.

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Let me thank the Council on Foreign Relations and Mr. Rubin for giving me the opportunity to address this distinguished audience.

The current difficulties faced by certain Spanish savings banks have their roots in a long expansion in the Spanish economy dating back from 1996 to 2006. It was a period of sharp growth in employment, activity, and wealth. At the same time the budget deficit diminished drastically and the level of public debt over GDP fell below 40%. However, the expansion was also accompanied by some imbalances. House prices rose substantially; the current account deficit climbed significantly, reflecting in part the loss of competitiveness, and in part the need to fund investment rates that rose to around 30% of GDP, targeted not only on increasing residential investment but also on investment in equipment and infrastructure; Spanish households and firms increased their debt levels notably, in response to low interest rates prompted by euro area membership, reflecting their asset purchases (real estate assets in the case of households, and productive assets in the case of firms, coinciding with a major internationalisation of Spanish corporations).

The big financial crisis that began in 2007 had a very limited impact on the asset side of Spanish banks. In Spain, neither conduits nor SIVs (Structured Investment Vehicles) were developed, because the Bank of Spain obliged banks to consolidate these vehicles and required capital of them for the attendant exposures, which eliminated at root any incentive to create these off-balance-sheet vehicles. Accordingly, Spanish banks had hardly any toxic assets. They did not use the originate-to-distribute model to distribute credit risk but pursued a retail banking strategy, in close proximity to bank clients, households and firms alike. On the liability side, when the mistrust and uncertainty worsened, European banks began to suffer the consequences, and their difficulties in raising funds increased. Nonetheless, the long-dated maturities on these products in the past (around 10 years) meant that Spanish banks did not undergo pressing short-term liquidity problems.

The financial crisis passed through rapidly to the real economy, with output slumping heavily in late 2008 and over much of 2009. The economic downturn in Spain, and the subsequent recession, impacted banks and progressively raised their doubtful assets and, therefore, their provisioning requirements. Their volume of activity, and new lending in particular, decreased, and the high profitability of Spanish deposit institutions seen so far, began to be eroded. The impact of these developments was uneven, impacting with greater force those banks that had most grown in the expansion and, in particular, a group of savings banks that had concentrated a significant portion of their lending portfolio in financing real estate developers. Expectations about house prices, which had started to lose momentum in 2006, changed and prices began to fall, in a much more unfavourable macroeconomic setting and with financial institutions much more cautious about extending credit given the rise in bad debts and provisions, and the tightening of funding conditions.

In view of these problems, the Government and the Bank of Spain began to take decisive measures to tackle this "classic" crisis based on credit to the real estate market and to the abrupt change in cycle, as well as to the changes in the markets.

Firstly, to address the uncertainty on funding markets, a programme was set up that would allow banks to issue debt with the backing of the State and the ECB started to inject liquidity allowing full allotment. Secondly, the Fund for the Orderly Restructuring of the Banking Sector (FROB) was created in 2009. With the FROB we anticipated the need to equip

ourselves with an instrument to carry out a far-reaching restructuring of the savings bank sector.

The scale of the savings bank restructuring process has been huge. Of the 45 previously existing savings banks, only 17 remain. The aims of the process were very clear. First, to take advantage of the concentration processes to restructure assets and correct the excessive fragmentation of this sector. Second, to reduce the excess capacity in the savings bank sector. The adjustments are between 10% and 25% in the number of offices, and between 12% and 18% in staff. Third, to reinforce the viability of the new institutions (resulting from the mergers of several savings banks) with the resources and the management capacity of the savings banks best placed to lead each of the concentration processes. Finally, to ensure in the medium term that the lower number of institutions and the diminished capacity will allow a reasonable level of profitability in step with the risks incurred for the remaining institutions. To round off the adjustment, the legislation governing savings banks was also amended in an attempt to make the management of these institutions more professional and, most notably, opening them up to market discipline and to the possibility of them raising capital (shares) to reinforce their solvency.

In short, the central aim of the efforts made by the Bank of Spain since 2009 has been to restructure the balance sheets of banks, and of savings banks in particular. Spanish deposit institutions have made an enormous write-down drive to date, this effort often going unnoticed by certain observers of the Spanish banking system. Overall, provisions totalling €91 billion which is a 9% of GDP, more than the cost of numerous bank crises experienced by developed countries. These major provisions have been possible because Spanish banks, with their retail business and the significance of their banking franchise, were able to obtain high levels of profitability in the recent past, despite maintaining some of the lowest levels of leverage among European banking systems and having to retain a portion of such profits under the system of countercyclical provisions in place. On top of that, Spanish banks have increased their capital buffer over minimum requirements by €53 billion – around 5% of GDP – in the last three years.

After the first crisis of mistrust, the Greek debt crisis, the Bank of Spain, within the European Union, led the disclosure process through the carrying out and subsequent publication of stress tests which, in a coordinated fashion, were conducted by the European supervisory authorities. Spain, whose weight in the Community banking system is around 8%, was represented in the stress tests by 27 banks, 30% of the total number analysed. This figure meant that information on 90% of the Spanish system was disclosed, compared with the minimum of 50% required by the European authorities. All listed Spanish commercial banks and all savings banks were subjected to this exercise. Significantly, the exercise consisted of very tough scenarios for Spain and it was carried out under the attentive eye and control of the Spanish supervisor. For instance, it assumed that the Spanish economy was going to undergo a second recession, with a cumulative fall in GDP of close to 3 percentage points. This was far from the market consensus and the actual figures, given that the Spanish economy ended 2010 with a growth rate of 0.6%. Further, the haircuts applied to assets were most notable: 28% in the case of housing, 50% in that of uncompleted housing and 62% in that of land prices. In addition, a fall in net operating income of 40% was assumed, one of the most severe for all the countries involved in the exercise.

Let me insist on the rigor of our stress testing, as some have broadly criticised the test because some banks from other countries were given a seal of approval only to collapse a few months later. Not only we tested all the banks but the information published by Spanish banks for the stress test was more detailed than that of the other countries. Our aim was to enable analysts and investors to check the stress test for themselves and know what volumes of problem exposures and expected portfolio losses were involved.

As a result of the measures mentioned (greater disclosure, amended regulatory framework for savings banks and progress in restructuring), Spanish banks, not only the leading ones

but also a large number of medium-sized banks and savings banks, were once again able to re-fund themselves on international wholesale markets, although the cost of funds continued to reflect the sovereign risk premium.

The process of concentration and restructuring was making good progress as from last summer, when the second episode of mistrust – the Irish crisis – struck around November 2010. The public debt markets tightened immediately and there was a resumption of mistrust about the Spanish banking sector, doubts over the quality of its assets, the speed of savings bank restructuring and the possible need for further public funds to redress bank balance sheets, which in turn further strained the risk premium of the Kingdom of Spain.

Although there are important differences between Spain and Ireland in several dimensions, the market perception of potential similarities between both economies, however distorted this is, impacted us. In anticipation of further problems, the government and the Bank of Spain, in its capacity as banking supervisor, understood the necessity to speed up the strategy we had pursued to tackle the difficulties experienced by part of the Spanish banking system. We insisted all the more on the need for institutions to be fully transparent concerning potentially problem lending. Early this year we obliged all savings banks to disclose their exposure to real estate developers, their non-performing loans, and the portion of normal exposures under surveillance, their coverage and information as to what collateral is backing such lending (land, housing under development, completed housing, etc.). They were also asked to publish information on foreclosures, by collateral class, and on exposure to households via house mortgages, along with the attendant loan-to-value ratios, although this is not an area for concern.

Transparency and disclosure are very important but we believed it was not sufficient. We have thus been working closely with the Vice-President on strengthening our banks' solvency. A result of this has been the recently approved Royal Decree-Law, which we believe is a definitive step and a crucial quantitative and qualitative leap forward in restoring market confidence in Spanish banks.

The aims of the new Royal Decree-Law are very clear. The first is to reinforce the solvency of all our banks, requiring them a level of core capital of 8% and because the doubts of investors over a small group of unlisted banks with some need to resort to the wholesale market, we are demanding of such banks 10% of core capital.

We publicly announced yesterday which banks need capital to reach the 8–10% level, and how much capital they need. We have given them fifteen days to submit a recapitalisation plan. Those intending to tap the markets will have until end-September to attain the new level of capital. But we have made it very clear that if a bank believes it will be impossible to reach these solvency levels, it can apply to the FROB for these funds. The capital shortfall is for a maximum of €15.152 million, whereby the impact on public debt if the FROB has to be used would be relatively limited. By the way, let me remind you that the Spanish public debt to GDP ratio at the end of 2010 stood at 60%, well below those of other euro area countries.

Allow me to conclude by addressing some of the doubts raised by investors, which it is our duty to try and resolve.

The first message I wish to convey is my absolute confidence in the Spanish banking system's solvency. The measures we have taken in the past for their restructuring are beginning to bear fruit (creation of banks, market orientation, downsizing, etc.) and the recently adopted measures, specified yesterday, along with the pressure we are exerting on our banks to increase their solvency, should raise confidence in our banks and dispel doubts about their present and future situation.

It should be stressed that our asset valuation system is very demanding, both in terms of the classification of problem assets and of provisioning and write-downs. Savings banks, with exposure to the construction and real estate developers sector of €217 billion, have €28 billion of doubtful loans, in which the borrower is not paying interest or repaying the

principal. As Banco de España requirements stand, banks have, in addition to the foregoing amount, to record as problematic the assets foreclosed in payment of debts. Even more, standard loans under special surveillance owing to weaknesses observed in them are also considered as problematic. These rigorous asset classification criteria indicate that potentially problematic assets at savings banks in credit to construction and real estate developers are €100 billion, 46% of the total. The specific loan loss provisions set aside for these problem assets account for 31% (if we added general provisions, the figure would be 38%). Obviously, the specific provisions considered to compute these figures are those associated to this potentially problematic loans and not the total amount of specific provisions.

Spain's system of specific provisions has been tightened to drive banks towards making tougher and swifter provisions. A non-performing loan, once the value of the collateral has been taken into account, should be fully provisioned in one year. Collateral value is considered using significant haircuts, which range from 20% in the case of completed housing to 50% in that of land. Provisioning must also be made for foreclosures, up to 30% if they have been on the balance sheet for two years. The provisions are determined by means of transparent parameters, compliance with which is obligatory for all banks. This means they are not the subject of negotiation between bank managers and external auditors.

In sum, Spanish deposit institutions are not hiding potentially problem exposures, and nor are the figures for losses small or the provisions made low or far removed from the fair value of these assets. We are very transparent and rigorous in valuing assets and we will continue to be so in the future.

Admittedly, 2011 is still going to be a difficult year for Spanish banks, with their net interest margins under pressure owing to the higher marginal cost of funding and to rather flat business volumes, and with the need to continue making loan loss provisions to write down assets. However, banks have room for manoeuvre to combat these negative pressures on profitability through acting on costs, which should begin to reflect the impact of the restructuring processes. If provisioning requirements persist along with pressure on the margin, the banks most affected should consider additional cost-containment measures. Looking ahead, resumption of notable economic growth for 2012 and successive years, in keeping with market consensus forecasts, together with the culmination of the savings bank concentration and restructuring processes, bringing about synergies, cost cuts, efficiency gains and a substantial reduction in the number of players, will all shape a positive scenario for the recovery of profitability in the Spanish banking sector.

I should further point out that net interest income as a percentage of total assets in Spanish banking business has not changed much over the past four or five years, with a ratio of around 1.25%. True, there is more pressure on marginal rates, but their impact on average margins is fairly slow. The marginal cost of funding has risen, but the average cost in 2010 was lower than that observed in the five previous years. Sometimes there is confusion between new rates and average rates.

As regards funding, our banks have a relatively reasonable wholesale funding maturity structure, with nearly half of the maturities after 2013. Around 20% of the debt issued on markets matures this year. The recent measures to reinforce solvency should, along with headway in restructuring, allow our banks to re-fund when the foregoing maturities fall due without excessive strains, although probably at still-high costs. Evidently, there was a bout of tension last year in the funding of Spanish banks when the wholesale markets practically shut down following the Greek sovereign debt crises. Spanish banks – inevitably – resorted to a greater extent to the ECB. Once the tensions began to evaporate, Spanish banks immediately returned to the wholesale market to place covered bonds, senior debt and guaranteed debt. This response by Spanish banks is very positive and shows their willingness to cut to the full the resort to the ECB. Indeed, our ECB funding levels are currently slightly below our relative weight in the euro area.

I have so far talked about those areas where we have risks and concerns. I would not wish to wrap up without mentioning an area where we do not have problems. This is, namely, banks' and savings banks' exposure to households via mortgage loans for house purchases. Other countries have serious problems with their mortgages, but in Spain the doubtful assets ratios ended 2010 at levels below 3% in this lending portfolio segment, which accounts for more than one-third of the total portfolio. Elsewhere, in credit to construction and real estate developers, bad debts are around five times greater. These mortgage default figures are somewhat more than one percentage point lower than those observed in the early 1990s, when we also had a recession combined with a real estate market crisis. And this is possible with the unemployment rate currently around 20%. The explanation for this is that interest rates on Spanish mortgages are currently below 3%, while in the early 1990s they were around 14%, with an unemployment rate close to 24%. The fact that the average loan-to-value ratio stands at 62%, with only 3% of mortgages with an LTV above 100%, and the widely rooted wish in Spanish society to own one's own house explain why the mortgage portfolio is, in fact, the least risky of all Spanish deposit institutions' credit portfolios.

Conclusions

I could talk a good deal more about what we have done in Spain to tackle and resolve the problems of our banking system. But I believe it would be much more interesting to listen to your concerns and worries and try to allay them. I shall thus conclude that the steps taken by the Spanish government and Parliament on fiscal consolidation, labour market reform and pensions system reform, along with the changes I have explained to you in relation to savings banks and the strengthening of banking solvency, should – little by little, since confidence takes some time to pick up – afford us greater recognition by international investors. Recently, in fact, we have seen how our sovereign spread has been converging more towards the core euro area countries, distancing itself from those economies with bigger challenges outstanding. Our firm commitment to transparency, to the rigorous valuation of assets through a clear provisioning system and our significant increase in capital requirements should contribute to fully dispelling doubts about the current situation of Spanish banks and their medium-term prospects.

Thank you for your patience. I am at your entire disposal to respond to your questions.