TEN QUESTIONS CONCERNING THE SPANISH BANKING SECTOR

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"Fate gives us the hand, and we play the cards"
William Shakespeare

1. Introduction

The Spanish banking sector finds itself at a delicate crossroads at which an important number of questions remain unresolved. Together with the much-awaited economic recovery and the reduction of unemployment, the resolution of the problems of solvency and the need for restructuring which affect financial intermediaries constitute probably the most important and urgent challenges which must be faced in Spain. A solution to these difficulties of the financial system is a necessary condition for sustainable and lasting recovery. If the situation facing the Spanish banking sector is analysed, similarities are clear with other international experiences, but so is a problem specific to Spain –in which the exposure of the banking sector to the domestic property market is significant- which requires its own solutions and which, for various reasons, is making itself felt later than in the majority of neighbouring economies. This time lag –considered by many to be involuntary, since the crisis arrived relatively late to Spain- is becoming a cause for concern since, in specific scenarios, greater efforts than those foreseen may be necessary to tackle the restructuring and reassessment required and avoid a greater crisis.

The present article reviews the principal questions concerning Spanish financial intermediaries in the spring of 2010, grouped together into ten points. In addition to this fairly broad but not necessarily exclusive or exhaustive recapitulation, an attempt is made to repudiate certain convictions which have established something of a foothold in recent months and which require clarification. Among these, for example, is the idea that the crisis only affects the savings banks. Despite these having to date been responsible for the majority of the current projects of integration and restructuring, the economic-financial crisis affects the banking sector as a whole. Although some of the questions considered here require differential treatment in the case of the savings banks (for example, how to diversify the possibilities raising equity capital), most of the questions and challenges posed in this article (asset impairment, solvency, default, exposure to the property market and difficulties of liquidity, among others) affect not only the savings banks, but also the commercial banks and credit cooperatives.

One of the principal vicissitudes faced by financial intermediaries is the situation regarding credit –or the lack or weakness thereof- and its importance for productive investment and economic growth. In a context such today's, however fervently wished-for, the increase in bank lending in Spain cannot be directed or fomented artificially; beforehand, the banking sector must undergo a necessary restructuring and reorganisation. This explains the importance of these processes, since the Spanish economy –whose productive flexibility and competitiveness is lower than many of its competitors- is unlikely to undergo a "creditless recovery". In the coming months we shall inevitably witness a crucial moment for the future of the financial system and of the Spanish economy as a whole, in which the restructuring of the banking sector is destined to play a necessarily leading role. The experience of the majority of European countries and of the United States, where the banking crisis became evident earlier and in a more synchronised manner, appears to have demonstrated –to date, at least- that in such a delicate context the least conventional solutions may be, in some cases, the most practical. In any event, the evidence resulting from this and past financial crises indicates that burying our heads in the sand and waiting for an exogenous improvement to the situation is not a viable solution. On this point, the present article also aims to call attention to the need for leadership and resolve in the Spanish bank restructuring process, in which both the role of the central government and that of the Bank of Spain will be fundamental for the actions and reforms necessary for a smooth transition.

Following this introduction, the article is structured in three sections. Section 2 poses and develops –the list is neither exclusive nor closed- what we consider to be the ten most important questions concerning the Spanish banking sector in the face of the crisis. We have employed the form of questions, although challenges or problems would also be apt. Section 3 reflects upon the generalised character of the financial crisis in Spain –although the effects upon individual entities display important disparities-, which does not exclusively affect any institutional group. The article ends with a review of the principal conclusions in Section 4.

2. Ten questions concerning the Spanish banking sector

We now list ten of the principal questions and problems which, in our judgement, the Spanish banking system must confront. This review will provide us with a reference point for the magnitude and complexity of the financial system's difficulties, in regard to which we shall subsequently analyse the solutions so far contributed, as well as other alternatives for their resolution.

2.1. Risk strongly concentrated in the real estate sector

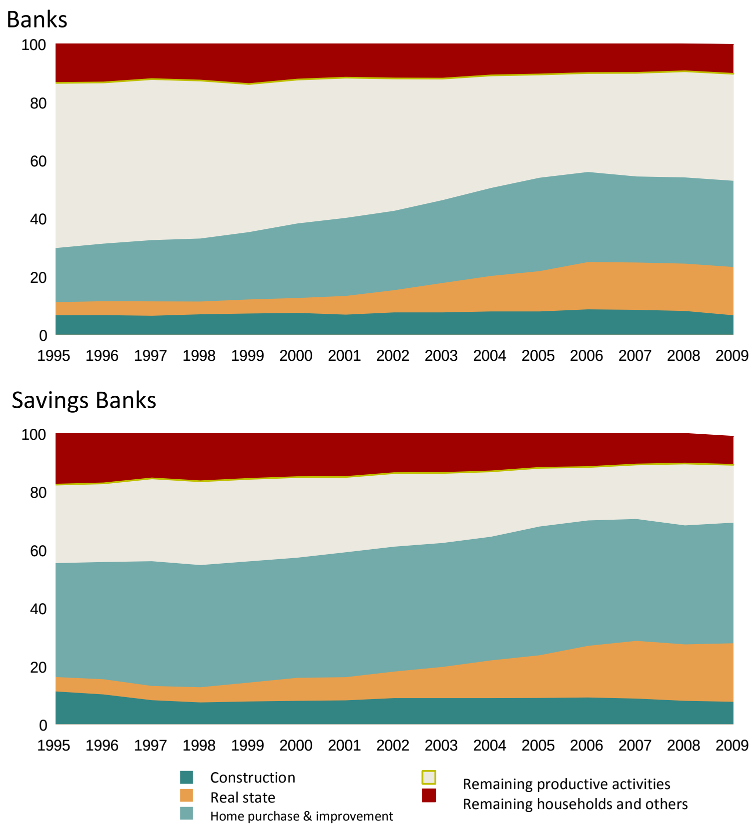
A broad consensus exists that a significant part of the problems currently affecting banks in Spain is the consequence of the heavy concentration of credit in those activities related to "bricks and mortar", especially property construction and development. The intense rate of growth of financing to this sector (including mortgages) is evident; this figure has risen from 38.8% of total credit in the mid-1990s to 60.3% in 2009, to reach 1.11

trillion euros (over 100% of GDP). The fastest growth has occurred in credit destined to property development, whose rate of variation reached a maximum value of 50.6% in 2006, with an average annual growth rate of 30.5% in the period 1995-2007.

Analysing banks by type, the heavy concentration of risk in the property market is greater in the case of the savings banks' portfolio, which provided 69.3% of total credit to the private sector (604 billion) in December 2009, compared to 53.2% from the banks (424 billion). The extra 180 billion, compared to the commercial banks, which the savings banks maintain in such loans is largely explained by an initial specialisation in mortgage loans, where the outstanding balance of the savings banks exceeds that of the commercial banks by 122 billion euros. The difference in credit for the property development (the balance of the savings banks exceeds that of the banks by 43 billion euros) and construction sectors (16 billion more in the case of the savings banks) is lower (Figure 1).

When analysing the exposure of financial intermediaries to the real estate and property market, it should be underlined that for such credit growth to be achieved, these intermediaries have increasingly turned to asset securitisation, regarding which various considerations are worthy of mention. Since 2003, securitisation has been on the increase, and although at the outset the principal issues corresponded to cover bonds, in recent years there has occurred a significant growth in mortgage-backed securities. The difference between the two types of fixed-income securities is not insignificant, since covered bonds are backed, with regard to investors, by the credit portfolio as a whole of the issuer, while mortgage-backed securities are backed, with regard to investors, by the assets with which the funds were constituted. Thus, it is commonly considered that covered bonds are fundamentally a liquidity generation mechanism, while bonds may additionally lead to, a transfer of the risk of their component loans. According to data from the European Covered Bond Council, Spain was the European country with the highest stock of covered bonds in the EU in 2008, amounting to over 330 billion euros. Similarly, according to the European Securitization Forum, issues of mortgage-backed securities may have exceeded 200 billion euros in Spain since 2003, a figure only surpassed in the United Kingdom. Such figures suggest, on the one hand, that liquidity requirements have been great and, on the other, that the problem of exposure to the property market may have been to a certain extent shared, through the purchase of bonds by other countries desirous of Spanish mortgage-backed securities. These circumstances are a potentially systemic element of the Spanish banking sector's exposure to the property market.

Figure 1. Relative importance of home mortgages, property construction and development in Spanish banks and savings banks (percentages)



Source: Bank of Spain and authors' elaboration.

It is also important to note the measures adopted over the last year by the Bank of Spain and the central government to “alleviate” the effects of the establishment of provisions for these risks in “bricks and mortar”. For example, in July the Bank of Spain relaxed the provisions regulation (establishing that, for certain properties, it is only necessary to make provision for that part of the mortgage which exceeds 70% of the value of the property, and not 100% of the loan as previously). More recently, on 9 April 2010, the Council of Ministers agreed to maintain until 31 December 2011 the transitional rule for the valuing of developable land, in accordance with the determinations contained in recently revised Law on Land, maintaining the classification of developable land although building has not taken place. Although this extension will help, without any doubt, to maintain the sector’s healthy balance sheet, it may delay yet further the necessary adjustment if unaccompanied by complementary measures to facilitate the reorganisation and reassessment of the sector.

Finally, an additional risk derived from the marked concentration of credit in the real estate and property market is the adequate management of the assets adjudicated and acquired in accord and satisfaction and a potential tightening of the Bank of Spain’s regulations regarding provisions (for example, in certain noncurrent assets for sale which remain for more than one year on the balance sheet).

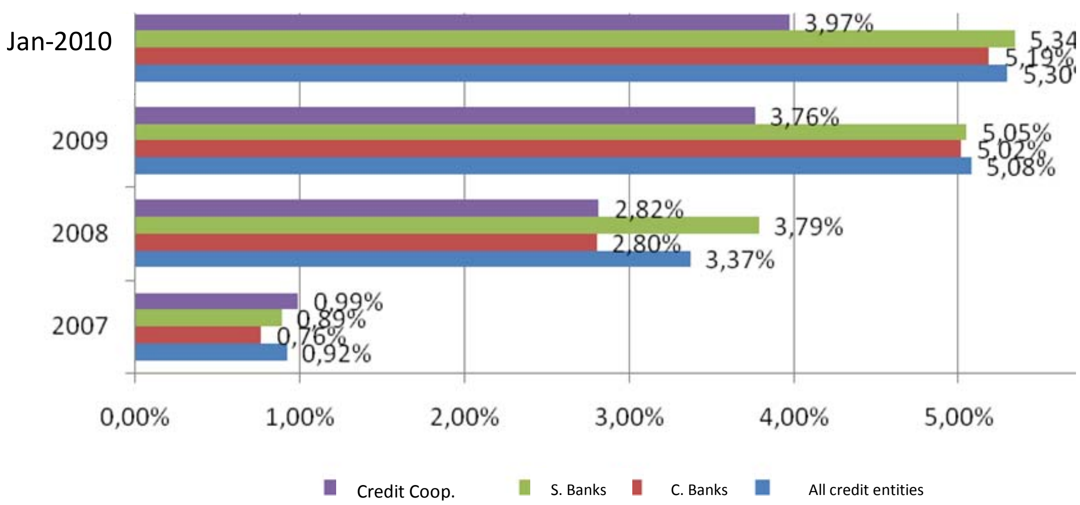
2.2. Increases in default and asset impairment

The greatest challenge faced by the Spanish banking sector is that of confronting increases in the rate of default and, in general, the impairment of assets, in an unfavourable macroeconomic context. The Spanish macroeconomic scenario (with negative GDP growth rates and an increasing unemployment rate) and the serious crisis suffered by the property sector significantly affect the default rate suffered by financial intermediaries. Thus, as the most recent available information shows, for January 2010

(Figure 2), the loan default rate of Spanish banks was 5.30%, having increased sharply since the end of 2007, when it was only 0.92%. Such rates have not been seen since the mid-1990s, although they are lower than the historic maximum reached in 1993 (almost 9%), precisely the year in which intervention into Banesto was required.

The analysis of default by loan destination demonstrates the existence of important sectorial differences. Thus the highest rates are in property development (10.06% in December 2009) and in construction (8.49%), with the rate for personal loans also being very high (7.63%). By contrast, in loans destined for home purchase, the rate of default is significantly lower (2.89%). If we compare the defaults on loans destined to productive activities (company loans) to those made to families, the rate is higher in the former (5.08% vs. 3.68%).

Figure 2. Recent evolution of loan default in Spain



Source: Bank of Spain and authors' elaboration.

The comparison on an international scale of default levels is complicated, due to both methodological reasons (the definition of default is not internationally standardised) and to the time interval regarding the availability of information. Given these restrictions, the most recent data from the IMF in its Global Financial Stability Report of October 2009 estimated the default rate affecting the Spanish banking sector to be 3.4% (as of December 2008), compared to a rate of 2.9% in the EU and 3% in the United States. Consequently, the latest information available places default in Spain above that of these two regions, thereby demonstrating the magnitude of the problem in the Spanish banking sector.

Such rapid growth in defaulted assets has necessarily affected the coverage ratio for provisions, which, in the specific case of loans, fell from a maximum value of 322% in 2004 to 58% in January 2010. Fortunately, the Bank of Spain's requirements –which oblige Spanish banks to establish provisions to create a safety cushion in times of economic boom, to be used during downturns- have so far made such an important increase in default easier to bear, since from the outset coverage was high, the provisions for which have largely been already consumed. In fact, in December 2009, general provisions were already lower than specific provisions.

One indicator which underlines the current importance of default for the Spanish banking sector is the magnitude of the operating margin after subtracting for asset impairment (provisions). According to information provided by the Bank of Spain in its latest Financial Stability Report (March 2010), in 2009 almost 70% of this margin was allocated to provisions, largely general and specific. In 2006, this percentage was only 20%.

Leaving the operating margin on one side and employing current accounting terminology and data from the Bank of Spain itself, it is similarly possible to perform an exercise which demonstrates the current magnitude of the problem of asset impairment. In particular, the accounting statements of domestic banks for the fourth quarter of 2009, published by the Bank of Spain, show that in the case of the banks non-financial asset impairment amounted to 3.64 billion euros, while the write-off of financial assets was calculated at 1.87 billion euros for that quarter alone. If we add to this impairment the operating expenses of 3.79 billion euros which must be met, the figure rises to 9.30 billion euros. It might be added that the gross margin of the banks was 9.57 billion euros in the fourth quarter of 2009, and thus bank profits practically disappeared in the in this period.

In the case of the savings banks, financial asset impairment in the same period amounted to 3.03 billion euros and that of non-financial assets to 1.84 billion euros. Adding operating expenses to these items of asset impairment (3.49 billion euros), the savings banks had to meet obligations of 8.35 billion euros when their gross margin in the fourth quarter of 2009 was 6.74 billion euros. Consequently, the savings banks began to suffer losses in the fourth quarter of 2009.

It must be remembered, moreover, that as 2010 progresses, default will continue to increase and it may well begin to do so faster and more severely in the banks than in the savings banks, given that the default relief which to date mortgage lending has required will very probably be monopolised by personal and business loans, for which there exist few or no collateral guarantees and to which the banks have allocated a greater proportion of credit than the savings banks.

2.3. What possibilities are there for business model change and franchise value recovery?

Spanish financial intermediaries significantly increased their granting of loans in the years prior to the crisis, fundamentally to finance home purchase and property construction and development. As evidenced above, in a context of meagre results, asset impairment losses hinder profit generation. In the absence of clear investment alternatives, it is complicated to achieve the principal objective, beyond the crisis, of the banks i.e. a stable path of sustainable income and viability. The Royal Decree/Law 9/2009, which regulates the Fund for Orderly Bank Restructuring (FROB), considers viability can be both demonstrated by and demanded from financial institutions. Nevertheless, asset impairment has meant that, foreseeable, the viability of a certain number of banks is in doubt, and the principal channel for recapitalisation plans will be mergers and takeovers, as the supervisory body has repeatedly announced.

How can business be reoriented? In the coming years, it is unlikely that the financing assigned to bricks and mortar –whether for home purchase or for construction and development- can significantly increase. The situation requires a change in the financial model and the recovery of franchise value through the financing of other activities, profitable for companies and individuals, in projects with the capacity for productive and technological diversification. On this point, it is fitting to wonder to what extent the banking sector –and the Spanish economy itself- is prepared to foment this type of financing in industrial and service sectors with important innovation components. Such risks are less familiar to the Spanish banking sector, overly specialised in bricks and mortar, and must be immediately assumed, in order to develop know-how in these innovative businesses. The development of these new activities and products requires the dedication of resources; this is a somewhat difficult task in the current juncture, hindering the transition to a new banking business based far less on the financing of property-related activities.

It is convenient at this point to mention the recent “war of deposits” waged in the Spanish financial system, in which certain Spanish banking entities are offering, in specific conditions, rates of interest which are extremely attractive and clearly removed from the current path of rates for savings. Is this strategy part of the Spanish banking sector’s new business model? It is likely that this trend is due to not only the strategy of some institutions to increase market share but also to the difficult access to international finance and to the important debt maturity payments faced by many Spanish banks and savings banks. Nevertheless, there appears to be something else behind the implementation of such a strategy in such a delicate situation with tight operating margins. Evidently, financial institutions are private businesses and freely take their business decisions in a free market, but it must be recognised that this type of strategy does not appear to be wholly in line with the "more prudent banking" model advocated in forums of international organisms and central banks[1].

Lastly, viability requires improvements in efficiency. In this regard, at the end of 2009 operating margin increases were closely correlated with the capacity to control the operating costs of in the absence of significant increases in revenues. This relationship can be observed in Figure 3, which compares operating efficiency –proxied by the ratio "operating costs/gross income" and the generation of recurring income–proxied by the ratio "operating income/average total assets"- for the 11 largest banks and the 45 savings banks. The Figure also shows that the achievement of high levels of efficiency or of the generation of profits from recurring income is not necessarily linked to greater bank size (reflected in the size of each bubble on the figure).

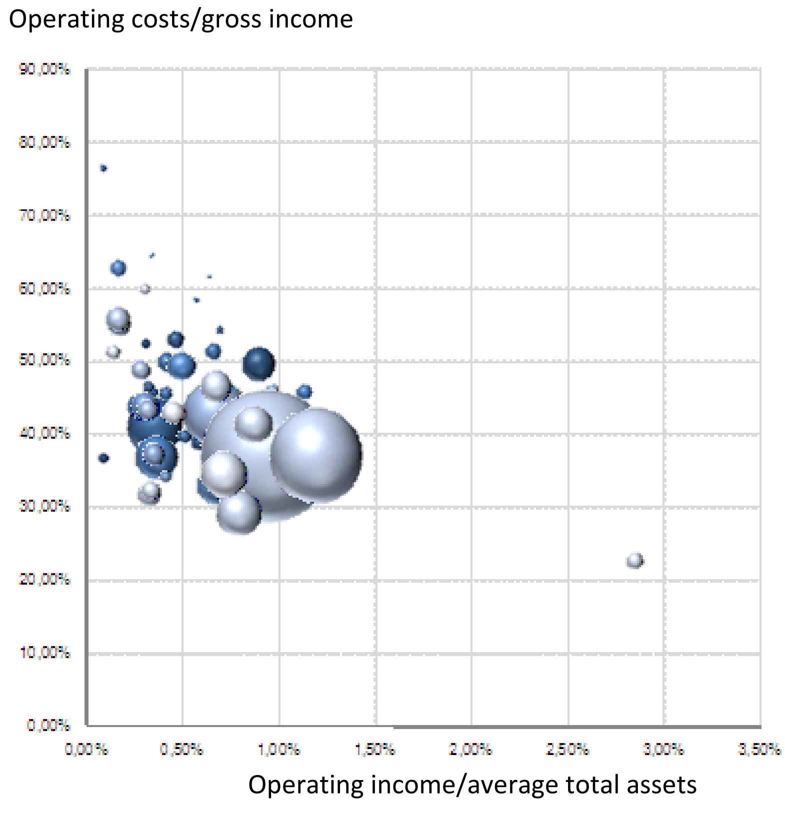
2.4. Difficulties in access to wholesale financing sources

The intense growth rate of credit in Spain which took place in a context of economic expansion from the mid-1990s until the onset of the crisis was financed by access to international wholesale markets, since national savings (and thus the deposits of Spaniards) were insufficient to finance investment. This resort to the international markets

[1] Although a causal relationship does not necessarily exist, it cannot be forgotten that the best-known precedent for the "war of liabilities" occurred in the early 1990s and coincided with a notable fall in margins and with various difficulties in certain financial entities (Banesto was the most notorious case).

brought about a reduction in the deposits/loans ratio, which fell from 111% in 1997 to 90% in 2009, and is currently below the eurozone banking sector average (93.2%).

Figure 3. Efficiency (operating expenses/gross income) and recurring income (operating income/average total assets) in the Spanish banking sector (2009)
Note: bubble size corresponds to firm size (total assets)



Source: Spanish banking associations (AEB and CECA) and authors' elaboration

Given that the international crisis which began in the summer of 2007 generated a paralysation of international markets and serious difficulties in issuing and trading with securities abroad, Spanish banking firms have been striving to capture deposits, producing an increase in the deposits/loans ratio from 2008 to the present day. These difficulties in the access to international financing may be one of the reasons –together with expectations of interest rate rises in the medium term- explaining the current competition on the liabilities side, with a very aggressive pricing policy displayed by certain entities.

In the current juncture of high public deficit, the risk premiums required of Spanish public debt end up affecting banking debt, which hinders yet further access to international markets. If to this we add the lowered rating which some agencies have awarded to the Spanish banking sector, access to wholesale financing becomes a serious challenge. Furthermore, the progressive withdrawal of liquidity-supporting measures by the European Central Bank (such as the elimination of 6- and 12-month auctions), the stagnant securities market, the finalisation in June 2010 of the State guarantee for bank debt issues, together with public sector borrowing requirements, mean that the problem of liquidity management continues.

2.5. Reduction of bank margins

In the period of intense growth in banking activity which took place between 2002 and 2008, the balance sheet of Spanish financial-monetary institutions increased at an average annual rate of 12.9%, far above the eurozone average (7.2%). In 2009, however, due to the economic crisis, this figure increased by only 1.1% in Spain (-2.2% in the eurozone), with negative rates of growth of credit to the domestic private sector (-1.8%), both companies (-3.8%) and households (-0.8%). Classified by financing destination, the credit squeeze is most intense in the construction sector (-14.1% in 2009) and in consumption loans (-9.1%), while mildly positive rates exist in the services sector (0.4%) and in property development (1.7%), in the latter case certainly as a consequence of the refinancing operations undertaken to tackle short-term default.

Logically, such a sharp fall in banking activity and the need to tackle asset impairment affects balance sheets and profitability. Yet this is not a problem which affects exclusively the Spanish banking sector, but instead is internationally generalised. In fact, even in the crisis year of 2008, the ROA of the Spanish banking sector was the highest in the European Union, with a profitability of 0.68%, compared to 0.10% for banks in the EU-

15. In 2009, in turn, according to information contained in the Financial Stability Report by the Bank of Spain, the ROA of Spanish banks (profit attributed to the group) fell from 0.73% in 2008 to 0.54% in 2009, clearly demonstrating the effects of the crisis, as a consequence above all of the insolvency provisions made. In particular, and as stated above, losses due to asset impairment reduce the operating income by 67%.

Similarly, the forecasts for 2010 are far from promising, for several reasons: a) the low and even negative growth rates for activity in a context of a negative GDP growth rate (of -0.4%, according to the Bank of Spain); b) the disappearance of the positive effect associated with the fall in interest rates which meant that in 2009 financial costs fell more sharply than financial revenue, given the different speed of adjustment of the rates of assets and liabilities; c) the intense competition to capture deposits, as banks offer deposit rates far above the Euribor and interest margins consequently fall; and d) the need to continue establishing provisions to tackle the expected increase in default, in a context of negative GDP growth rates and increasing unemployment. The decline in profitability will be even greater if there is any delay in the process of restructuring the Spanish banking sector, essential to reduce operating costs and thereby increase efficiency.

2.6. <u>How important are agency ratings and what impact may a lowering of the sovereign debt rating have?</u>

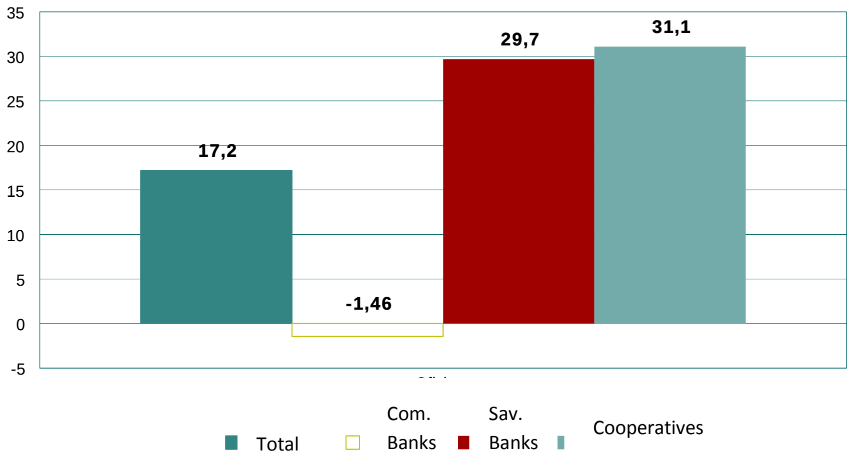
Despite the ratings agencies having been and continuing to be sharply criticised for their (failed) role in detecting the risks inherent in those securities responsible for a large part of the so-called sub-prime crisis, they continue today to be a fundamental reference point in determining the current situation and perspectives of solvency of economic instruments and agents, including financial entities. In the framework of the FROB, Royal Decree-Law 9/2009 widened the range of requirements of the Bank of Spain to include the elaboration of action plans for contingency situations, including asset impairment, equity capital scarcity, the incapacity to generate recurring income/ or the loss of foreign confidence. In this last case, the ratings agencies are precisely the principal reference point.

What is more, the so-called “sovereign debt crisis” in Europe has led to the ratings attaining, if such were possible, even greater prominence, and their pronouncements and ratings significantly condition investment decisions in financial markets worldwide. The agencies consider features such as the economic strength of the country, evolution of GDP, institutional strength of the government, legal and administrative regulation, among others) and the financial discipline of the State (debt repayment capacity, financial institutions solvency). However, on occasions there exists a fragile equilibrium which determines the step from one rung to another of the sovereign debt rating for a specific country, and the predictive capacity of these agencies is doubtful. In this connection, eurozone Finance Ministers and the European Central Bank (ECB) already aspire to liberate themselves from dependence on the existing agencies and create their own ratings agency for the sovereign debt of European countries. However this should be configured, the maintenance of a high debt rating is fundamental in a context in which indebtedness has increased considerably and must be reassessed. Equally, the determination of the quality of sovereign debt is fundamental for the rating of any financial institution and this, in turn, for access to the capital markets for such banks. Here, the dispelling of doubts which may exist regarding the quality of Spanish sovereign debt satisfaction is a fundamental condition for banking restructuring, even more so when access to FROB funds by banks requires a high rating to be maintained.

2.7. Excess capacity in the banking sector

In a context of a strong rhythm of growth of bank credit, Spanish financial intermediaries implemented a substantial expansion of their network of branches, which increased by 18% (6,700 offices) from 1997 to 2009, in complete contrast to the reduction observed in the EU. For years Spain has occupied leading positions in the European ranking in terms of network density, which in 2008 was 989 inhabitants per branch, compared to the average of 1,730 in the eurozone banking sector.

Figure 4. Variation (%) in Spanish bank branches (2000-2008)



Source: Bank of Spain and authors' elaboration

Although the expansion of the branch network can be interpreted as an improvement in the quality (proximity) of banking service, it is important to bear in mind that branches are the principal generator of operating costs, and thus in the face of the current decline in the rhythm of banking activity growth, the reduction of costs necessary to maintain efficiency demands a rationalisation of the branch network. This message has been persistently transmitted by the Bank of Spain, calling for the required restructuring of the sector by aid from the FROB. In this regard, much remains to be done, although the reduction of the branch network is beginning to be felt. Between September 2008 and December 2009 1,700 branches were closed in Spain, and there are currently 44,728. Although, as Figure 4 shows, the increase until 2008 was highly unequal among banks, savings banks and cooperatives (between 2000 and 2008 commercial banks reduced their network by 1.5%, while the savings banks and cooperatives increased theirs by 30% and 32.5% respectively), office closure since the end of 2008 has been shared equally between banks (closing 807) and savings banks (799), while the cooperatives have lost 16 offices (Figure 4).

2.8. Can the credit supply be increased to meet private sector financing needs?

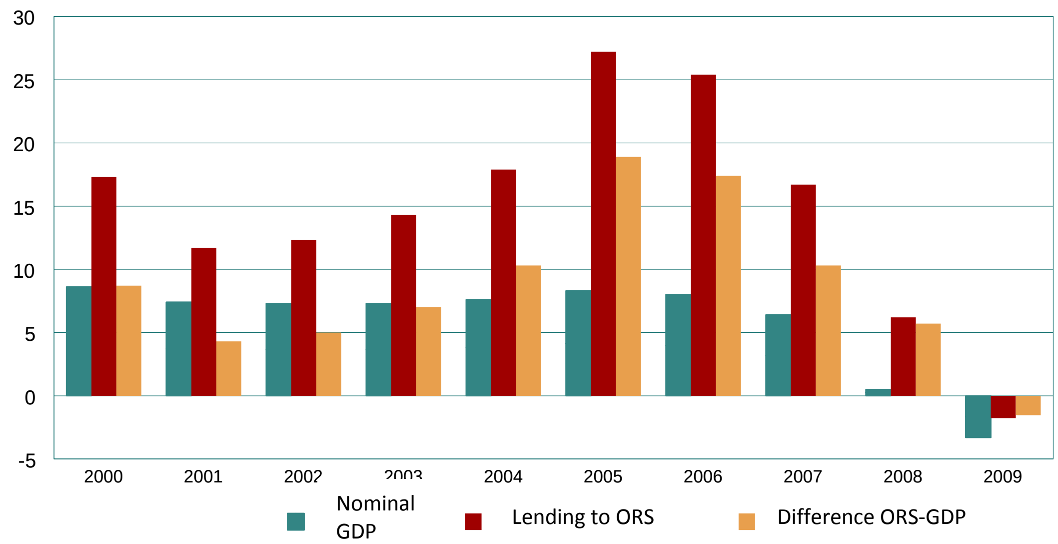
In recent months the perception that bank financing has been cut off has become generalised, bearing in mind the sharp fall in the growth rate of credit in Spain, which reached annual rates of over 25% in 2005 and 2006 (well above nominal economic growth) and currently displays negative variation rates. Here it is important to remember that GDP variation is also negative (-3.3% in nominal terms in 2009 and -3.6% in real terms), meaning that credit continues to "increase" more than GDP (Figure 5). Furthermore, investment, the variable most directly related to credit suffered in 2009 a real fall of 15.3%, while consumption dropped by 4.9%, and it is therefore logical that the demand for credit plummeted.

The above notwithstanding, such a sharp fall in credit may also respond in part to the banking sector "turning off the tap", for various reasons: a) because entities must tackle important problems, such as containing default; b) because in a climate of uncertainty and crisis, the degree of risk aversion increases (as shown by the strong rhythm of growth in 2009 of public debt in the hands of the Spanish banking sector, reaching 54%), which becomes a problem of credit rationing; and c) because they must meet debt maturities, which in turn requires that new deposits must be destined to refinancing and not to the granting of new loans.

Although it is difficult to determine the relative contribution of supply and demand factors to the decline in credit, the surveys performed of both banks and companies by the

European Central Bank are potentially enlightening. In the former case, the latest survey regarding SME access to financing, in February 2010, indicates that in Spain 25% of bank loan requests had been rejected in the previous six months, compared to an average figure of 18% in the eurozone (7% in France, 15% in Germany and 18% in Italy). The same survey reports that the availability of bank financing has declined more sharply in the case of Spain, since 48% of the companies surveyed answered that they encounter greater difficulties in obtaining finance, compared to 32% in the eurozone (14% in France, 29% in Italy and 15% in Germany). Finally, on the question of future expectations for access to bank financing, 15% of the companies surveyed notice a deterioration, compared to 6% of eurozone companies. In summary, the companies surveyed confirm a tightening of the conditions for access to bank credit.

Figure 5. GDP and credit to the domestic private sector (ORS: other resident sectors) growth rates in nominal terms (2000-2009) – percentages



Source: Bank of Spain and authors' elaboration

On the supply side, the survey on bank loans (the last being in January 2010), confirms the growth of risk aversion on the part of the banks, in the form of stricter conditions for financing. In particular, concerning variations in the criteria for loan approval, an increasing percentage of banks from mid-2007 to mid-2008 responded that approval criteria were tightening, although since early 2009 this figure has fallen. Since 2007, at all events, the percentage has always been positive, implying the tightening of conditions for financing.

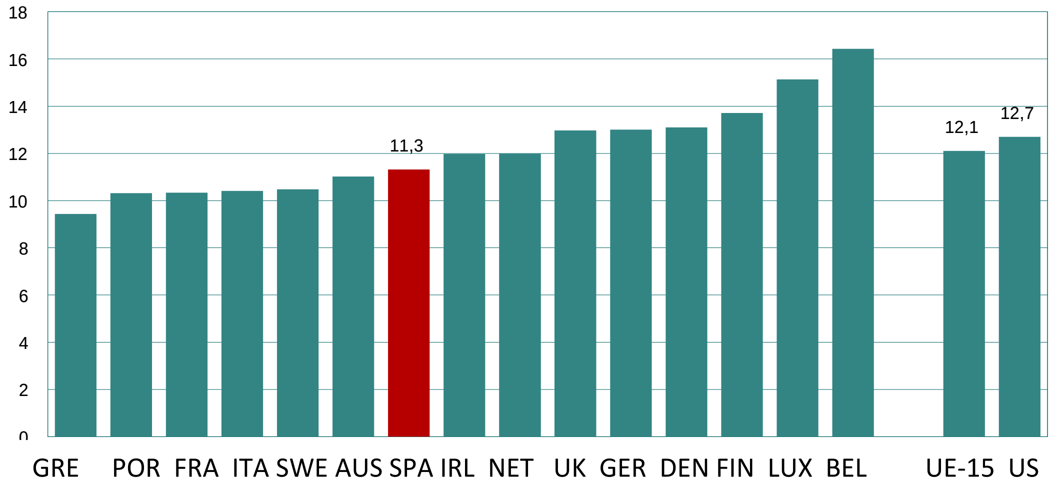
What does the future hold? As stated above, while other of the questions posed remain unresolved (increases in default, difficult access to financing, increasing solvency, etc.) and the macroeconomic scenario of the Spanish economy fails to improve (meaning there will no solvent demand), credit recovery in Spain will be very difficult.

2.9. Regulatory changes and increased equity capital requirements

In the international context, although information for 2009 is not available, ECB data for 2008 (Figure 6) establish the solvency coefficient of the Spanish banking sector at 11.3%, below the average of both the UE-15 (12.1%) and the USA (12.7%, according to IMF data). Warning should be given here that international comparisons of the solvency coefficient must be performed with great caution, as a result of public injections of capital (amounting to 215 billion euros in the eurozone countries) which, for the moment, have not been necessary in Spain.

In a context of economic-financial crisis, in which the market demands more than ever that entities maintain a sufficient cushion of equity capital to meet possible losses, Spanish banks increased their solvency coefficient in 2009 by almost one percentage point, to 12.2% (9.7% for Tier 1 and 8.1% for core capital); this was the result of both a reduction in risk-weighted assets and an increase in equity capital (principally preferential shares and reserves).

Figure 6. Solvency ratio in the EU-15 and the US (2008)



Source: ECB and IMF (for USA)

The current concern is the effect which the highly probable raising of the solvency requirements may have upon Spanish banks, in the new regulatory framework for capital (already termed “Basel III”). Thus, the proposals (in their consultation phase since December) of the BIS to strengthen the resilience of banking sectors are aimed at: increasing the quality (fewer hybrid instruments –preferential shares, subordinated debt- and more core capital) and quantity of capital, standardising the definition of capital, penalising indebtedness (by imposing maximum debt ratios), reducing procyclicality and encouraging buffers against adverse cycles, and attempting to deal adequately with systemic risk and interconnectivity.

Of such proposals, Spain is familiar with those intended to counter credit procyclicality –for example, general provisions - yet the likely raising of the solvency coefficient (currently 8%) and the necessary improvement in capital quality (not forgetting the substantial preferential share issues in Spain, which may cease to be computed as Tier 1) are a serious challenge for the near future. Obviously, the effect of Basel III is potentially greater for saving banks, due to their institutional characteristics. This, more than ever, requires the reform of the legal framework for capital certificates, since in the current scenario these appear to be the only means by which the savings banks can increase their core capital.

2.10. Effectiveness of the restructuring process and governance and transparency issues

Tackling the reform of the financial sector requires awarding greater weight and priority to those actions and institutions supporting this process. The Fund for Orderly Bank Restructuring (FROB) was intended to become the framework into which the principal changes were to be inserted. However, no bank or merger project has yet, as this article is being written, obtained funds from the FROB and, although it is foreseeable that such funding is finally granted, this is symptomatic of the delay in this reform. Current argument maintains that this type of financing will be costly (in the region of 7-8%) and furthermore that the deadline for application is somewhat peremptory, as it expires on 30 June 2010. Nevertheless, this deadline is renewable and, as regards costs, the FROB contributes something currently invaluable for Spanish financial intermediaries: capital with the highest rating. It is predictable, at any event, that the process will accelerate in the coming months and that integration projects will intensify. As an alternative, mutual support systems (SIPs), have also been established; these are mutual aid and support mechanisms for their member entities, whose primary objective is to guarantee the liquidity and solvency of all their members, while permitting each to maintain its identity and legal nature. SIPs are not mergers, since their participants maintain their legal nature and their decision-making capacity in many respects. SIP projects are beginning to proliferate in Spain, particularly among savings banks. Nevertheless, it seems reasonable to expect that success (in the eyes of the supervisor, and for practical motives) will only come to those able to agglomerate a sufficiently high critical business mass among solvent and viable entities. It may be that institutions with greater solvency problems are left with no recourse but the path of pure mergers.

In the midst of this set of projects and rumours of integration, there also exist multidimensional proposals for regulatory reform concerning the savings banks. Despite their having been and largely continuing to be an entity model which has significantly prospered in the Spanish retail market (for more than half of whose business they are responsible), the financial crisis has made clear the need for change, above all in the obtaining of equity capital. Here, capital certificates are rapidly becoming the most viable alternative, as they are equity capital which can be given maximum classification (core capital) and are potentially able to originate voting rights, which would make them even more attractive in capital markets[2]. Similar experience in this area includes the case of the Norwegian savings banks, where capital certificates (called there primary capital certificates) have developed and award to holders (with certain limitations) voting rights and the possibility of representation on management bodies. At the same time, it is said that these reforms may require a greater professionalization and depoliticisation of the corporate governance of the savings banks[3]. No well-managed institution should fear these proposals, which may once and for all close the debate on the changes necessary for the savings banks.

At all events, the part must not be mistaken for the whole. The reform of the Spanish banking sector concerns all its entities and stems from a property-based problem and from the generalised impairment of assets and, in certain concrete cases, from a lack

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[2] On the need to increase the equity capital of the savings banks in the context of the crisis, see Carbó and Rodríguez (2009).

[3] In this regard, references have recently been made to the model being adopted by Caja Navarra, CAN, in which the reform of its statutes establishes that no member of the Management Board or of the Assembly may hold public or political posts.

of management diligence. The resolution of this question in the coming months is essential. On this point, and even when taking into account the principle of prudence which must guide the actions of the financial supervisor, it would be convenient to increase the transparency of the workings of financial entities and of their exposure to risk, placing at the disposition of citizens information regarding such exposure, the composition of entities' credit portfolios and their solvency and risk levels. Furthermore, if informational transparency had been greater, it may be that the analysts (including academics) would have given much earlier warning of the problems in the sector. It is possible to provide more data regarding the composition of balance sheets and risks incurred without this infringing policies of confidentiality or representing any competitive change. The example of the profuse reports (the so-called call reports), required by the Federal Deposit Insurance Corporation (FDIC) from North American banking firms and which are quickly made available to the public would appear to be a good benchmark. The obligation to publish the so-called Prudential Relevance Reports (Law 36/2007, 16 November) is a step in the right direction, yet more information must be supplied to avoid "almost blind" interpretations of accounting items both individual and lacking detail. Finally, but by no means less importantly, if the regulator had obliged credit entities to supply more information to the market, some entities may not have reached their current level of risk concentration in bricks and mortar, since they would have been more closely subjected to market discipline.

3. A generalised crisis

Although there currently exist 45 savings banks and 65 banks in Spain, with very different specialisations, sizes and "states of health", generic talk is of the strengths of the banks and the weaknesses of the savings banks in the current context of economic-financial crisis. To judge by the average data for the two types of entities, shown in Table

1, there exist certain differences between banks and savings banks, favourable in some cases to the banks (concretely, in terms of profitability and efficiency, and similarly their lower exposure to the property sector), although in other aspects (such as default and the coverage ratio with provisions) the differences are increasingly slight and may even be changing sign in some indicators (e.g. the default rate in some sectors). From among the illustrative data the following are worthy of comment:

a) In 2009, bank profitability (approximated by the accounting profits as a percentage of assets) was 0.6%, compared to 0.2% for the savings banks.
b) The banks' operative efficiency (operating costs as a percentage of gross margin) at the close of 2009 was 40.1%, compared to 46% for the savings banks.
c) Bank capitalisation, as a percentage of assets (not weighted for risk) was 8.5%, compared to 7.8% for savings banks.
d) The rate of loan default affecting the banks was 5.2% in January 2010, compared to 5.3% for savings banks. By sector, the default rate suffered by the savings banks is greater for residential mortgages (3.09% vs. 2.48%) and construction (8.98% vs. 7.84%), and lower than that of the banks regarding loans for property development (9.72% vs. 10.59%) and personal loans (4.41% vs. 8.17%). Thus, the principal problem of exposure to risk, that concerning "bricks and mortar" and loan default, affects not only the savings banks: in some cases, in fact, it is sharper in the banks.
e) The coverage ratio of loans (general and specific provisions) is 57% for the banks and 56% for the savings banks.
f) The concentration of credit in construction and property development amounts to 23.2% for banks and 27.8% for savings banks; these figures rise to 53.2% and 69.3% respectively if loans for home purchase and improvements are added.

The above information regarding the average of the two types of intermediaries should be interpreted cautiously, since the average data for both groups conceal important within-group differences. This warning should be heeded, as the Bank of Spain has repeatedly reminded us in recent statements. To give the most recent example, in March the Bank published its latest Financial Stability Report, which at various points comments upon the heterogeneity of the set of Spanish deposit entities.

Table 1: Comparison of banks and savings banks: December 2009 (except where indicated)

Margins and profitability	**Banks**	**Savings banks**
Gross margin (% average total assets, ATA)	2.1	2.3
Profit from operating activities (% ATA)	0.7	0.4
Accounting profit (% ATA)	0.6	0.2
Costs and efficiency		
Operating expenses (% ATA)	0.8	1.1
Operative efficiency (%)	40.1	46.0
Capitalisation		
Equity capital (% ATA)	8.5	7.8
Default and coverage		
Loan default (%). January 2010	5.2	5.3
Construction	7.8	9.0
Property development	10.6	9.7
Home purchase	2.5	3.1
Personal loans	8.2	4.4
Coverage provisions (%) January 2010	57.0	56.0
Credit concentration in property market (%)		
Property development	16.6	20.1
Construction	6.6	7.7
Home purchase	30.0	41.5
% Bricks and mortar = prop. dev. + construction (over total ORS, other resident sectors)	23.2	27.8
% Bricks and mortar (homes added) (over total OSR)	53.2	69.3
Growth of activity (annual growth rate)		
Credit growth rate ORS (January 2009 – January 2010)	-2.8	-1.3
Balance sheet growth rate (January 2009 - January 2010)	-2.0	3.0

Source: Bank of Spain

To demonstrate that these problems affect all types of banks, Table 2 shows, by way of example, the maximum and minimum values of four relevant variables (ROA, operative efficiency, capitalisation and the importance of asset allocation); these confirm the existence of a wide range of variation both within the savings bank sector and, more markedly, within commercial banks. For example, the ROA of the savings banks varies from a minimum value of -3.15% (corresponding to Caja Castilla La Mancha, under intervention since March 2009) to a maximum of 1.05%. In the banks, however, the range is still greater, from a maximum of 3.7% to a minimum of -2.9%. The range of variation is always greater for commercial banks, above all in terms of operative efficiency (with an interval ranging from a maximum of 140.4% to a minimum of 20.6% at commercial banks, compared to 77.5% vs. 33% at savings banks) and of capitalisation (46% vs. 2.3%, compared to 10.7% vs. -1.1%). In terms of the relative importance (balance sheet weight) of non-current assets for sale (which increased sharply in 2009 as a result of allocations and accord and satisfaction), both sectors show enormous differences among entities. Interestingly, the highest value corresponds to a commercial rather than savings bank.

Table 2: Range of variation in banks and savings banks (consolidated groups) in selected indicators (2009). Percentages

SAVINGS BANKS	**MAXIMUM**	**MINIMUM**
ROA	1.05	-3.15
Operative efficiency	77.49	32.97
Non-current assets for sale/Total assets	4.57	0.00
Equity capital/Total assets	10.73	-1.14
BANKS		
ROA	3.70	-2.88
Operative efficiency	140.39	20.61
Non-current assets for sale/Total assets	4.61	0.00
Equity capital/Total assets	46.12	2.33

Source: Spanish banking associations (AEB and CECA) and authors' elaboration

4. Main conclusions and implications: are there sufficient instruments available to undertake the reorganisation and restructuring of the Spanish financial sector?

The Spanish banking sector finds itself at a difficult crossroads. The present article has reviewed the principal questions and problems currently determining its future and confirming the urgent need for restructuring and reorganisation. Factors such as the marked exposure of lending to the property and real estate sector and the associated significant impairment of assets, the reductions of margins and profits, the difficulty in increasing credit and changing its orientation and, finally, the need to reinforce solvency in order to face up to a new regulatory and competitive framework, are some of the symptoms of a patient in delicate health. Spain has developed a resolution mechanism based on the FROB; although advancing somewhat slowly, it will necessarily accelerate in the coming months. Whether this will be sufficient, without recourse to less conventional reorganisation mechanisms, remains to be seen.

Our final reflections follow a dual approach, the first more theoretical and conceptual and the second more pragmatic, establishing comparisons with the experiences of other countries. With regard to the former, economic analysis has wound the national banking safety net around two main dimensions: deposit insurance and solvency. Understanding the economic policy of these two mechanisms goes beyond the simple instrumentation and application of norms, since imperfect information means that the safety net is stretched by vested interests and public and private pressures. The objective, in all cases, is to avert banking risks and, above all, the concurrence of systemic crises. If we consider the current components of the safety net in a country such as Spain, it may be thought that the deposit insurance (following the generalised increases in these guarantees in the autumn of 2008 throughout Europe) does not constitute a problem. Nevertheless, there exists the latent risk that any eventual intervention into a bank would produce –as has in fact occurred- significant movements of deposit accounts from certain intermediaries to others, which may lead to greater destabilisation.

In any event, the fundamental component of safety net, upon which all eyes are currently focused, is solvency and, by extension, adequate risk coverage and bank success itself. On this issue, however, the tendency is to examine entities (and the system as a whole) statically, arguing that solvency levels are located at a specific level on a specific date. A dynamic analysis –one going beyond balance sheets and static accounting items- requires analysing how solvency is changing. A very simple yet illustrative example is the analysis of capital/assets ratios. A considerable part of the Spanish banking sector is increasing these ratios, but it would be convenient to analyse to what extent they are the result of increases in the numerator (more capital) or reductions in the denominator (less activity, product of disinvestments). This is no trivial question, because increasing capital ratios through the reduction of activity entails lower levels of investment and a loss of operative capacity, which in part may be inevitable to correct excess capacity. Spain is not alone in its excess capacity, although other economies have already adopted perhaps more forceful measures (fundamentally, capital injections).

Presenting a diagnosis of the situation of the banking sector would require, as would a doctor faced with a patient, having available the greatest quantity of information and diagnostic tools possible. It would also mean recognising the possible repercussions which any government aid may have upon the taxpayer, as making society understand the enormous costs of the irresponsible use of public health care similarly requires. It is currently especially necessary, when public funding is involved, to establish responsibilities, apply discipline to managers who have not been diligent and establish prompt-corrective action mechanisms to prevent the recurrence of such problems of management and supervision.

Within the responsibility we all hold, we economists appear to bear a considerable part of the burden, yet it is also true that while worldwide the debate seems to have shifted to a different level (the reactivation of lending, prevention mechanisms, the role of contingency capital, possible taxes on certain financial activities, vigilance over systemic entities), in Spain we are apparently still in the resolution phase of this banking sector crisis, and this is not because the economists –the greater part of whom have no responsibilities in the financial or political worlds- have not advocated and proposed resolution scenarios and measures for the financial system of the future. Unfortunately, these proposals from Spanish economists appear to have attracted more attention abroad than at home[4].

In other respects, from a more practical viewpoint, if we analyse the experience of other countries in similar conditions to Spain (low economic growth, collapse of the property market following a price bubble, a significant increase in unemployment, increasing public deficit, etc.), we find that many of them turned to direct injections of capital to resolve asset impairment and the uncertainty surrounding banks. This was the case of the controversial TARP program (*Troubled Assets Relief Program*) in the United States and, more or less extensively and with its own peculiarities, of other European countries such as the United Kingdom or Germany, which procured sufficient capital resources from the public sector to shape up balance sheets and rejoin the path of financial stability. The most recent experience of this has been in Ireland, where after various attempts at “calm” restructuring through discipline and reorganisation and in the hope of an improvement in macroeconomic conditions, the urgency of the problems of asset impairment have led to the creation of a “bad bank” (the National Asset Management Agency or NAMA), which will be responsible for removing such assets from banking

[4] See, as a simple example, the respected forum VOX, for debate upon European economic policy (http://www.voxeu.org/).

balance sheets by timely injections of capital. There is no doubt that these are unconventional solutions which have significant repercussions upon taxpayers and increase the burden on public sector finances in the short term, but only time will tell if these costs would have been greater had such actions not been taken. What is clearly true is that by these initiatives an important number of countries have managed to eliminate a large part of the uncertainty enveloping their banking sectors. Similarly, in the light of the experience of the last two years in Spain, it is fitting to question whether the supervisory authorities have available sufficient tools for prompt corrective action and/or whether they must be given a greater role in the resolution of problems of potentially systemic importance. This spirit is influencing the reforms of financial supervision being undertaken in various countries, the United Kingdom being one example.

One of the difficulties of resolving the crisis in Spain lies in the recognition of expected loss, as performed in autumn 2008 by the majority of countries which injected capital into their financial systems. In the national case, expected loss stems largely from exposure to the property market. At the present moment, if the sums necessary to resolve the problem of solvency were equal to those already requested (more or less explicitly) from the FROB and those which have appeared in the media, the problem would not appear to be very important and it would be reasonable to expect credit to soon flow once more. However, the return to normality of credit flows does not appear imminent. Consequently, the key issue is to establish the expected loss today and that of the future, under specific assumptions. The design of accounting mechanisms to defer or delay the expected loss may help to “cushion the blow” but does not solve the problem, merely postponing it and increasing the international suspicions hovering over the Spanish banking sector. Forecasts exist of the evolution of property assets and mortgage/asset-backed securities and it would be possible to estimate the losses with which our banks will face (numerous estimations from multiple instances already exist in this regard).

As time advances it appears to become more necessary to consider other options, even if this means an additional burden, in principle in the short term, upon public finances. In specific circumstances, if actions are excessively prolonged they may ultimately cost more, in terms of both private and, probably, public costs. The experience of the last 30 months in Spain does not indicate an immediate or early reduction in the uncertainty regarding the process of adjusting and reorganising our financial system. In Spain, no public funds have yet been provided for writing off the troubled assets of banks. The FROB offers significant potential funding (to a limit of 99 billion euros), but at a high cost which the recipient banks must repay relatively quickly. Use is unlikely to be made of all or a considerable part of such these resources. Similarly, it is unlikely that if only a small part were used –the sums which are currently in process - the expected impairment losses could be definitively resolved and a response could be given to the questions surrounding the Spanish banking system this article discusses. Far more likely is that a limited use of these resources will only temporarily attenuate part of the problems, which cannot disappear if the economy and the property market do not reactivate sufficiently, and thus impairment loss may significantly increase in the future. In all probability, the potential resources from the FROB –and even those available from the deposit insurance through- will be sufficient to cover impairment losses and to undertake the restructuring and "slimming down" of the Spanish financial system, if they are employed appropriately through more agile mechanisms[5]. It is perhaps easy to venture opinions on these questions, given the position we are in, but we cannot rule out the need for actions additional to those foreseen to undertake this reorganisation of the Spanish financial

[5] As this study points out, the authorities of other countries have changed their "road map" concerning aid to the solvency of their financial systems and some have even changed the original destinations of aid programmes. This was the case of the TARP (Troubled Asset Relief Program), designed by the US government, which was initially destined to the purchase of toxic assets and then assigned to injecting capital into banks requiring it.

system. The proposal of reforms with a zero fiscal cost or without a recognition and explicit resolution of losses due to asset impairment appears increasingly unlikely to achieve this reassessment of the Spanish banking sector within a reasonable time. It is true that any change in the current framework would require the approval of the competition authorities of the European Commission, an obstacle which could be overcome by accurate diagnosis and an adequate programme of aid aimed at increasing solvency without competitive distortions. This hypothetical change in the orientation of aid towards solvency would not necessarily be more costly than the more than likely delay – which all the analysts already take for granted will occur – in the application of the FROB.

Finally, although the questions posed are not exclusive to a specific type of deposit entity (commercial banks, savings banks or cooperatives), the forthcoming changes in capital regulation most affect the savings banks, and therefore urgent reforms are required in the sector, aimed at incentivising particular methods of capitalisation. Moreover, given that the slowness of the restructuring process of the savings banks also depends on i) the conflicts of competencies between the Central Administration and Autonomous Communities in regulatory matters, and specifically in the authorisation of mergers and acquisitions, and, ii) the strong representation of the Public Administrations on their governing organs, it is essential to implement without delay the necessary reforms regarding these two questions, in order to accelerate the restructuring of the sector.

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