The Spanish Financial System: A restructuring that has not finished

15 November 2011
In Europe, several problems are pending, such as liquidity provision (ECB and guarantees for banks’ issuance), which is paramount, and balance-sheet cleaning versus high capital requirements as established in the recent EBA exercise.

The solvency of the Spanish system is not as bad as it may be inferred from the results of the recent EBA exercise, which does not address banks’ balance sheet problems, such as legacy or real estate assets.

The removal of the 9% core capital requirement for June 2012 may trigger a capital surplus, which could be used to clean the balance sheets, after a specific stress test is conducted.

In Spain problems are concentrated on the exposure to the real estate sector, which is heterogeneous among entities.

The restructuring of the Spanish financial system has not finished, as the cleaning of the balance-sheets has to continue, there is a overcapacity problem and governance should improve in line with the higher standards in place.
Contents

1. Spanish financial system: an European comparison

2. The problems of the Spanish financial system:
   - Solvency
   - Liquidity
   - Overcapacity

3. Next steps
Section 1

How has Spain funded its growth?

Spain has to reduce its external funding needs, a big proportion of which corresponds to the financial sector, which has intermediated those needs.

Spain: Gross funding needs vs. the rest of the World
(EUR bn)
Source: BBVA Research based on Bank of Spain

Spain: External funding capacity (EUR bn)
Source: BBVA Research based on Bank of Spain
Section 1

How has Spain funded its growth?

Despite this intermediation, the Spanish financial system has managed to keep a limited size and a low leverage ratio...

Size of the Banking System: Assets (% GDP, Sep-11)
Source: BBVA Research based on Bank of Spain and IMF

Leverage of the Banking System: Assets/Capital and Reserves (%, Sep-11)
Source: BBVA Research based on Bank of Spain
Section 1

How has Spain funded its growth?

... although the liquidity gap has been reduced only slightly since the crisis began
Section 2

Solvency: Are Spanish banks in worse shape than their European peers?

According to the most recent capitalization demands, a high proportion of the European capital needs corresponds to the Spanish banking system.

Why?

Does it make sense?

Estimated capital target buffers (EUR bn)

Source: EBA

Why?

Does it make sense?

* The sovereign capital buffer is indicative and can already be covered by existing CT1 capital if the CT1 ratio exceeds 9%.

** No information on the sovereign capital buffer has been provided by Greek banks, not to conflict with pre-agreed arrangements under EU/IMF programme.
Section 2

Solvency: Are Spanish banks in worse shape than their European peers?

1. “Happy families (banks) are all alike; every unhappy family (bank) is unhappy in its own way”. Leo Tolstoy

2. “In order to cover a hole with sand, we should first measure the size of the hole before putting together a huge amount of sand”

How could we improve the current exercise?
Section 2

Solvency: Are Spanish banks in worse shape than their European peers?

EU proposals for bank recapitalization are tilting to a model where mild stress testing on balance sheets is compensated with high capital requirements.

Decisions
- Haircuts: broadly based on market prices
- Deadline to comply with capital: June-2012
- Minimum capital levels: 9% (previously: 5%)

Risks/caveats
- May actually worsen sovereign debt problem in some countries
- Risk of asset reduction and credit squeeze, also to sovereigns
- Basel III calendar was designed to avoid exacerbating the contraction in the downturn
- Does not address banks' balance sheet problem

Why shouldn’t we go towards a specific and harder stress test coupled with lower capital requirements? Let us focus the institutions away from capital hoarding!
Section 2

Solvency: What are banks’ balance sheet problems?

The focus of the European exercise should have been placed in items such as legacy assets, high leverage ratios or real estate, depending on their exposure. We still have time before mid next year.

**Legacy Assets**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Legacy Assets (% Assets, Jun-11)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hypo Real Estate</td>
<td>45%</td>
</tr>
<tr>
<td>HSH Nordbank</td>
<td>40%</td>
</tr>
<tr>
<td>Commerzbank</td>
<td>35%</td>
</tr>
<tr>
<td>Agricultural Bank of Greece</td>
<td>30%</td>
</tr>
<tr>
<td>Dexia</td>
<td>25%</td>
</tr>
<tr>
<td>Societe Generale</td>
<td>20%</td>
</tr>
<tr>
<td>Credit Agricole</td>
<td>15%</td>
</tr>
</tbody>
</table>

* Also called restructuring non-strategic or non-operating assets

**Leverage Ratio: Assets/Own Funds**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Leverage Ratio (%, Jun-11)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural Bank of Greece</td>
<td>60%</td>
</tr>
<tr>
<td>Dexia</td>
<td>55%</td>
</tr>
<tr>
<td>Landesbank</td>
<td>50%</td>
</tr>
<tr>
<td>Hypo Real Estate</td>
<td>45%</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>40%</td>
</tr>
<tr>
<td>Commerzbank</td>
<td>35%</td>
</tr>
<tr>
<td>NovacapGalicia</td>
<td>30%</td>
</tr>
</tbody>
</table>

* Real Estate

Source: BBVA Research based on Bloomberg

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Solvency: In Spain, concerns are concentrated in real estate

Problems are concentrated on the exposure to the real estate sector

**Spanish Financial System: Assets**
(%GDP, June-11)
Source: BBVA Research based on Bank of Spain

**Spanish Financial System: Loans**
(EUR bn, June 11)
Source: BBVA Research based on Bank of Spain

- **Cash and deposits***: 1%
- **Securities**: 29%
- **Loans**: 183%
- **Shares**: 59%
- **Other Assets**: 40%

*Including interbank credit

**Loan sectors**
- **Housing**: 656
- **Construction and Real Estate**: 414
- **Consumption**: 149
- **Public sector**: 87
- **Non-Monetary Financial Institutions***: 120.3
- **Rest of corporates**: 550

*Insurers, pension funds, issuers of asset backed securities...

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*Includes interbank credit

**Loans to households, non-financial corporations, non-monetary financial institutions and public sector
Section 2

Solvency: In Spain, concerns are concentrated in real estate

Problems are concentrated on the exposure to the real estate sector, which is heterogeneous

Non-performing loans
(% credit portfolio)
Source: Bank of Spain

Exposure to real estate & NPLs
(June 2011)
Source: BBVA Research based on CNMV
Section 2

Solvency: wide range of estimates of capital needs

Diversity in estimates of capital needs (stress tests) ... but ≤ 10% GDP

- Analysts estimates use different assumptions for:
  - Forecast horizon
  - Macroeconomic and financial scenarios
  - Expected losses on portfolios
  - Profits before provisions
  - Minimum capital: core 8%, Tier1 6% etc.

- Official estimates: capital required to achieve a core ratio of 8% (or 9% to 10% in some cases) at the time of the test based on risk-weighted assets as of December 2010.

Spanish capital needs are below the 45% of GDP already injected in Ireland, and not far away from the 6% already spent in Austria or the 4% in Germany.
Addressing liquidity problems in the euro zone is paramount.

- The Commission has been asked to urgently explore the options to provide long term liquidity, such as guarantees for bank issuance, which are still under discussion.

- In addition, it would be worth considering:
  - Lengthening of ECB lending facilities (why not to 3 years?)
  - Penalizing banks for excess liquidity in the ECB deposit facility.
Addressing liquidity problems in the euro zone is paramount.

**EMU: Liquidity Tensions Indicator**

First normalized principal component of the following series: MRO+LTRO, margin lending facility, deposit facility, money markets funds non-government, OIS spread (3 M) and 3m EUR/USD cross currency basis, bp

**EMU: Summary of liquidity conditions**

Source: BBVA Research
Section 2

Liquidity: How does Spain fare?

The Spanish system has a solid deposit base, according to a retail business model.
Section 2

Liquidity: How does Spain fare?

Spanish debt maturities are significant but lower than in other peripheral countries in terms of % GDP

Financial institutions: Debt maturities (% GDP)
Source: BBVA Research based on Bloomberg, Dealogic and Bank of Spain

Spanish financial institutions: Debt maturities (EUR bn)
Source: BBVA Research based on Bank of Spain
Section 2

Liquidity: How does Spain fare?

Reliance on ECB funding slightly above capital key and small as % of GDP. Should it matter?

![Graph showing ECB liquidity over time]

**ECB liquidity (%total)**
Source: BBVA Research based on ECB

![Graph showing ECB liquidity by country]

**ECB liquidity (%GDP, Oct-11)**
Source: BBVA Research based on Bloomberg
Section 2

The restructuring process

There is still an overcapacity problem, if a target of 40% cost to income ratio is set

| Number of branches (Number) Source: BBVA Research based on Bank of Spain |
|---|---|---|---|---|---|---|---|
| 1993 | 2007 | 2010 |
| 30,000 | 32,000 | 34,000 | 36,000 | 38,000 | 40,000 | 42,000 | 44,000 | 46,000 |
| Dec-07 | Dec-08 | Dec-09 | Dec-10 | Jun-11 |

| Number of branches (Number) Source: Bank of Spain |
|---|---|---|---|---|---|---|---|
| 0 | 5,000 | 10,000 | 15,000 | 20,000 | 25,000 | 30,000 |
| Banks | Savings Banks |
Section 3

Next steps

Europe

Unfreeze liquidity constraints in euro area bank financing

A specific and truly comprehensive Europe-wide stress test

Spain

Stress the real estate sector

Should entities do it on their own (use of capital) or with public support (bad bank or asset protection schemes)

There is an overcapacity problem: need capital building buffers

Further signals of improvements in management

As regards the public intervention, the process of entry and exit of public capital should be quick and efficient
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Annex

Solvency and liquidity

Spanish institutions with capital problems are usually those with liquidity problems

### Core capital and ECB liquidity per financial institution

Source: Bank of Spain, CECA, individual accounts and BBVA Research

![Graph showing the relationship between core capital ratio and ECB liquidity](image-url)