Javier Arízteguí: Reform of the banking system

Speech by Mr Javier Arízteguí, Deputy Governor of the Bank of Spain, at the 5th Conference for financial professionals, Barcelona, 26 November 2010.

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Good morning. Firstly, I would like to thank the organisers for inviting me to participate in this forum. In view of the programme and the participants, I am sure that this is a good opportunity to debate the challenges facing the Spanish banking system and what the future holds for it.

I shall broach the subject of the transformations currently taking place at banks in two parts. The first part will describe developments in our banking sector since summer 2007 and the second will look in greater depth at the aspects I consider essential for assuring the progress which has already been achieved. At times like the present, when international financial markets are showing their aversion to risk and their discomfort with banking systems that are highly reliant on external financing, it is vital to consolidate this progress and to continue using transparency as the main means of showing investors the soundness of our banking system.

From summer 2007 to date

The crisis which erupted in summer 2007 has gone through various phases. At the risk of over-simplifying matters, I shall split it into three stages.

The first phase was characterised by a widespread loss of confidence: the complex structured products created in previous years came to be considered “toxic”. The institutions exposed to them and the amount of their exposure were unknown. Liquidity dried up and many banks experienced very heavy losses. These increased when off-balance-sheet transactions had to be returned to the books. The bankruptcy of Lehman Brothers in September 2008 was the trigger that brought the international financial system to the verge of collapse and marked the end of this period. Consequently, the authorities had to rescue the largest banks. This phase left us with a legacy of profound risk aversion which will take a long time to fade.

Throughout 2009, the second phase of the financial crisis interacted with a sharp decline in global economic activity. Corporations and households experienced a loss of wealth which, in turn, weakened the quality of assets on banks’ balance sheets.

The third and most recent phase of the crisis, which particularly affects Europe, has unfolded throughout 2010. It stems from the rapid deterioration of public finances in a climate in which markets are reluctant to keep financing increases in public debt that they consider may run into problems of sustainability. Simply put, this deterioration is explained by the loss of momentum of the European economy, the attempts of public authorities to alleviate its most painful effects on society and the consequences of States’ efforts to avoid the collapse of the financial system.

How have these three successive phases affected the Spanish banking system?

Spanish banks held up reasonably well in the first phase of the crisis. On various occasions, the reasons why they performed differently have been pointed out.

On the one hand, their business is “traditional retail banking”, which hardly involves structured products that can ultimately become “toxic”.

On the other, Spanish banking regulation and supervision retained its conservative stance and did not follow the international trend which advocated low-intensity regulation and supervision. Well-known examples are “dynamic provisions” and the compulsory consolidation of any “off-balance-sheet structure” that might involve a risk.

Nonetheless, our banking system has not been insulated from the consequences of the crisis. The sector built up imbalances during the long twelve-year expansionary period of our economy from 1995 to 2006. The interplay of these sectoral imbalances, which began to be tackled at end-2006 with the outbreak of the international crisis, suffices to explain the resulting impact.

On the assets side, there was a strong, sustained increase in lending. Coming in unison with one of the defining features of the Spanish economy’s growth pattern, the exposure to real estate developers turned out to be excessive, all the more so considering that it is a highly cyclical activity which is currently contracting sharply.

In this respect, it should be pointed out that in Spain there are fundamental differences between credit for real estate development and that extended to households for house purchase. Thus, while the former shows, as I have said, pronounced cyclical behaviour, retail mortgage lending is the type of credit which has the lowest default rates during recessions.

This is so not only now, when the doubtful assets ratio for deposit institutions as a whole stands at 2.5%, approximately 3.5 pp below that of credit to the private sector, but also in the past. For instance, in 1993, when the unemployment rate amply exceeded 20% and interest rates were substantially higher than at present, the doubtful assets ratio for house purchase loans was approximately 4.5 pp lower than that for total credit to the private sector.

The retail mortgage business in Spain is characterised by its simplicity, by having avoided innovations that tend to lower banks’ incentives to manage borrowers properly, and by the incentives to build relationships with customers, not only because the asset being financed is so important to them, but also because of the guarantees supplementing the mortgaged asset. Furthermore, the ratio between the loan value and the appraisal value is low, at 62% on average, and is similar across the various deposit institutions.

That said, I should emphasise that the protracted growth of activity resulted in redundant capacity. Under a traditional retail banking model, in which knowledge of customers and proximity to them are defining characteristics, it is natural to increase capacity in an upturn, for example, by opening more customer service points. It seems obvious, however, that the size attained by the branch network and central services at their peak did not match foreseeable developments in the banking business.

On the liabilities side, there were also imbalances. During the upturn, a growing share of the rise in lending was met by banks turning to the international wholesale markets. Savings banks, for example, which traditionally based their liabilities on attracting retail deposits, increasingly and irreversibly used foreign funding sources.

It should be underlined that the banks tapped this source of funding in a relatively prudent manner. Thus, most of these liabilities mature at medium and long term. Nevertheless, this greater reliance on the international markets has made institutions more vulnerable to a financial crisis which, as I have said, is marked by increased risk aversion and by the suspicion aroused by highly leveraged firms.

The impact of these tensions on assets, liabilities and structure has been more significant at savings banks or, to be more accurate, at some of them. They built up more imbalances because their decision-making mechanisms made them more sluggish when the time came to react and because their corporate model did not allow them to readily raise high-quality external capital and reduced the discipline imposed by the market on management.

Measures adopted to restructure the Spanish banking system

The larger imbalances at savings banks, together with the limitations inherent in their model, explain why the reforms centre on this segment in particular. The changes have consisted of pressing them to restructure and amending their legal framework.

The Fund for the Orderly Restructuring of the Banking Sector ("FROB" by its Spanish acronym) came into operation in September 2009. As you know, it can pursue two courses of action. The first, aimed at facilitating mergers of viable institutions, focuses on improving their efficiency in the medium term, strengthening the solvency of the post-merger institution and promoting a reduction of capacity. Thus, for example, the merger plans approved within the framework of the FROB envisage cuts of approximately 20% in the number of offices.

The aid given is conditional, since the institutions have to comply with a plan previously approved by the Banco de España; it is temporary, because the funds provided in the form of preference shares will have to be returned within five years; and it involves a cost, because these funds bear interest at 7.75%.

The second course of action open to the FROB is designed to achieve a swift and efficient resolution of the institutions which have not been able to overcome their difficulties and are no longer viable. If it is necessary for the Banco de España to take control of an institution and to replace its directors, the FROB contributes financial resources and ability to act. To date, this second form of action has only had to be used at CajaSur.

Consequently, the FROB has predominantly used the first course of action. Eight mergers have been approved and €10.58 billion in government assistance have been requested. The request yet to be made by Banca Cívica will be for an estimated further €1 billion.

Additionally, there are another five mergers under way which have not involved a request for assistance. In total, in the savings bank sector, there are 13 mergers taking place which affect 94% of assets and will reduce the total number of savings banks or groups of savings banks from 45 to 17.

The reform of the legal framework for savings banks, approved on 9 July 2010, has three objectives: first, to facilitate the issuance of top-quality capital; second, to contribute to promoting more professional management and governing bodies; and third, to enhance market discipline.

In order to facilitate access to capital markets, the reform sets out two possibilities. First, it provides for the issuance of equity units with voting rights. Second, particularly for those institutions with a business vocation which takes them beyond their traditional markets and businesses, three options are available. The first option is to join an Institutional Protection System (IPS) under the centralised coordination of a commercial bank. The second option is the transfer of the whole loan and deposit business to a commercial bank controlled by the savings bank. And the third option is the conversion of the savings bank into a foundation which manages welfare projects. This foundation is supported by the income from its assets, most notably dividends from the shares of the bank to which it transferred its financial business in exchange for the shareholding.

The goal of making the savings banks more professional is to reduce the maximum weight of public-sector stakeholders and to establish a regime regulating incompatibility.

Once it had completed this legal reform, Spain announced ahead of other European countries that it was going to stress-test its banking system to show that the market's perception of bank solvency was clearly lower than it actually was. Other European partners joined this initiative and by end-July 2010, the results of the stress tests had been published. As you are aware, compared with our European partners, the Spanish stress tests were far superior in terms of scope and transparency. In Spain, the decision was taken to stress-test the whole sector and not only institutions representing 50% of the sector. Furthermore, very extensive and detailed information was published.

The stress tests showed that Spanish banks as a whole were sound, despite taking into consideration very extreme and highly unlikely scenarios. However, they also served as a channel of communication because a lot of important information was disseminated.

At present international markets are once again questioning the reliability of the European stress test exercise. As I mentioned earlier, the Banco de España published bank-by-bank information, not only about the assumptions made, but also about the various portfolios and the funds available to cover hypothetical losses.

The Banco de España has recently once again revised the assumptions, parameters and estimates published four months ago and considers that they appropriately describe the current situation of the banking system and its exposures. The markets made a highly positive assessment of this transparency exercise and the banks, which are responsible for providing information to investors, should be the parties most interested in persevering with these market communication efforts.

From the approval of the measures to the current situation

The functioning of financial markets in the first half of 2010 was complicated considerably by the lack of confidence in the sustainability of public finances. At the height of the tension, the funding markets shut down and, consequently, many European institutions, including Spanish ones, resorted increasingly to funding from the Eurosystem since borrowers and lenders were no longer directly in contact.

As a result of the economic measures approved by the Government, the reforms of the banking sector and the publication of the stress tests, this tension eased from July.

Not only did the interbank market begin to function again, but many institutions were able to place €12 billion of bonds and notes on primary markets. This was reflected in the sharp reduction in funds requested by Spanish banks from the Eurosystem. At end-November 2010, funding from the ECB, which in July 2010 stood at €150 billion, fell back to €65 billion. This means that the Spanish banking system absorbs 12% of the loan from the European Central Bank, a proportion fully commensurate with its size and importance in the euro area and which represents 2.5% of its balance sheet.

The immediate future: consolidating the measures taken and putting the reforms on a firm footing

In recent weeks international financial market dynamics have continued to be influenced considerably by the high degree of risk aversion and by fragile confidence levels.

There has been a resurgence of the doubts – first seen in the case of Greece – about the solvency of euro area Member States. The uncertainty over the euro area's fiscal sustainability cannot be explained merely by the economic downturn and its impact on public finances. The measures taken by authorities to avoid the collapse of the financial system have involved, in the case of Ireland, guaranteeing the funds lent to the banking system by depositors and wholesale investors. Markets are suspicious about the ability of certain small States, with relatively large banking systems, to meet these commitments.

The European Union has come to the aid of Ireland, which has experienced problems precisely because it used substantial amounts of public funds to shore up a banking system bloated with real estate assets, particularly offices and houses in the Dublin area.

In Spain the situation is very different as regards both the public sector and the banking sector. Despite the substantial rise in the budget deficit in 2008 and 2009, public debt as a percentage of GDP remains relatively small in comparison with the euro area average, which is 20 percentage points higher. Furthermore, the Spanish State is committed to ending next year with a deficit of 6%, more than 5 percentage points lower than in 2009.

As for the quality of bank balance sheets, it is well known that non-performing loans have increased in recent years, and also that lending to the construction and real estate development sector was excessive. However, the stress tests have shown not only that banks have the capacity to absorb potential losses arising from extreme and highly unlikely scenarios, but also that most balance sheets comprise healthy assets in the various consumption and investment segments of the Spanish economy.

Despite these fundamental differences, the climate of uncertainty makes it advisable to reaffirm the adjustments promised by the authorities and to demonstrate to the international community that each major goal will be scrupulously met. I would like to point out four actions which I consider essential within this framework:

– ***First***, it is necessary to continue to restructure bank assets and full information should be provided in this connection.

  In the last three years, credit institutions have made notable efforts to recognise the impairment of assets on their balance sheets. This impairment recognition, effected through profit and loss accounts, amounts to more than €40 billion. To this figure should be added the possible use of a further €20 billion built up as a "general provision" since the introduction of countercyclical provisioning in 2000, and another €20 billion provisioned with a charge to equity in the mergers.

  In this asset restructuring drive, the Banco de España has considered it essential that the recognition of losses should not be deferred, in particular when real estate is acquired or accepted in payment of debts. These are not improper practices. They may be perfectly correct. But their use cannot lead to real estate assets becoming locked indefinitely into balance sheets.

  Accordingly, the approach followed by the Banco de España combines the detailed supervision of these operations with changes in provisioning regulations, so that the assets are valued at prices close to market, and are available for disposal at the best opportunity.

  These efforts must be fully and properly communicated. The Banco de España is going to require additional efforts from the banking sector in terms of transparency when the annual accounts are released and in the quarterly estimates the sector offers to analysts. Banks and savings banks will offer standardised supplementary information on the real estate development and construction portfolio and on the residential mortgage portfolio, detailing the corresponding collateral, the related loan-to-value data, their payment status and the coverage set aside for their potential impairment. The central bank, in coordination with the accounting authorities – ICAC and CNMV – is going to convene a meeting of the representative banking associations to agree on the technical formats for this information which, in any event, should be available by late March next year, when the consolidated financial statements of the new groups resulting from the mergers processes are released.

  In striving for clarity, the merged groups should place particular emphasis on explaining clearly and transparently how they have treated potentially impaired assets in the mergers. They should offer not only quantitative information but also explanations so that this information is interpreted correctly.

– ***Second***, banks should continue resorting to international markets to roll over their wholesale funding. As stated, the loan from the Eurosystem has progressively declined and institutions should persevere along these lines. It is vital to remain active in euro interbank markets, to participate in the central counterparty clearing houses and to resort to the primary markets and, insofar as the latter allow them, to extend the average maturities on their funding.

But they must also report to investors that business is as normal. The regular supplementary information I referred to in the previous point should include a section that reports on the status of wholesale funding, with a breakdown of instruments, the corresponding collateral and their duration.

– ***Third***, perseverance in the mergers under way, particularly in the savings bank sector, is vital. The progress to date has been most significant and institutions are meeting the deadlines.

  But further progress in this connection is needed, and there must be no wavering in the integration plans agreed upon. This phase foresees creating the new institutions and setting out the terms of their governance. Entities that integrate through "institutional protection systems" should have the attendant banks set up before the end of the year, with their boards of directors appointed and their managerial line perfectly defined. Achieving this, and the fact that, from January, the new institutions arising from integration processes will be operational, rolling over wholesale funding and negotiating on the markets on behalf and on account of the newly created groups, will lend consistency and reliability to the reform.

  Thereafter, a more technical and silent phase will begin, involving IT and operational adaptation, the elimination of redundant structures and staff adjustments which, as in all mergers, will take months. I am convinced that banks will tackle this process as professionally as they are completing the current phase.

– ***Fourth and finally***, cost structures must be speedily and thoroughly revised. In a Monetary Union, a country must compete in real terms abroad, as must financial intermediaries with one another, as a devaluation entailing an exogenous competitiveness shock is not an option. To overcome the crisis, reduce unemployment and improve the future outlook for the profitability of banking assets, there is no mechanism available other than to raise productivity and efficiency, to reduce labour and structural costs, and, consequently, to lower margins and prices so that all sectors, including banking, may offer better services within the country and sell more abroad.

  In the coming quarters, banks' and savings banks' profit and loss accounts will be subject to different factors of pressure. On one hand, because, despite the fact that the rate of increase of doubtful assets has eased, the setting aside of provisions for impairment will continue to weigh down profits. And on the other, because the narrowing of the net interest margin resulting from higher financial costs will hardly be offset by bigger volumes of activity.

  Accordingly, reducing overheads, which must be quickly and resolutely done, is the main instrument for softening these adverse effects on profits. Spain and the Spanish banking system need their creditors to roll over the funding they have extended to them. The best way of achieving this is to demonstrate day by day that banks and savings banks are healthy and profitable, and that their profit and loss accounts provide them with the flow of funds needed to honour all their commitments.

Conclusions

I shall conclude by reiterating the central idea in my speech.

The government has already taken various measures in the right direction. What is important now is to persevere along these lines, adhering to two underlying principles: budgetary austerity that provides for fiscal consolidation, and structural reforms.

As regards the banking sector, those responsible for its supervision and regulation, and most importantly the institutions comprising the sector, must complete the restructuring under way.

There can be no room for wavering, as that can only give rise to interpretations that undermine our creditors' confidence.

In sum, the reforms in train must be seen through, so as to cement international investors' confidence.

Thank you.