Miguel Fernández Ordóñez: Reflections on the Spanish banking sector and economy

Opening remarks by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the "XVIII Encuentro del sector financiero", organised by Deloitte-ABC, Madrid, 5 April 2011.

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Good morning,

I am most grateful to Deloitte and to ABC for giving me this opportunity to share with you some reflections on the banking sector and economy of our country.

In my talk I am going to take a hopeful view of the future of our economy and our banking system, based on the extent of the adjustment already under way and the progress made with fiscal consolidation and structural reforms.

Let no one be mistaken, I am speaking about the future, because the present continues to be dominated by an overwhelming statistic: the more than four million who are unemployed. Until this number is significantly reduced, nobody is entitled to even hint at the slightest satisfaction. But it is true that, for the first time since imbalances began to build up in the late 1990s, Spanish society seems to be prepared to change and to undertake reforms that are absolutely essential, not just for growth, but for solid and sustained growth. And such change, perceived and appreciated by the markets, is the main base for a hopeful view of the future, although there is clearly still much to be done and no time for any let-up in our efforts.

What has been done so far

I shall begin by examining progress to date.

At the time of the outbreak of the international financial crisis the Spanish economy and banking system had seen more than ten years of real estate expansion, excessive private indebtedness and continual competitiveness losses. Such imbalances had been generated in an environment characterised by very low interest rates and dominated by the absence of any significant structural reforms in relation to public spending, pensions, the labour market or savings banks. After ten years building up imbalances it was inevitable that the economy would have to adjust and reforms were essential to restore growth and employment as soon as possible.

If we examine what has happened during the two and a half years since the collapse of Lehman Brothers, it is clear that our country's economy and banking system have both made considerable progress in terms of adjustment and restructuring.

The private sector has made progress in reducing its imbalances at a faster rate than in other countries with similar problems: the external deficit fell from 10% of GDP at the beginning of the crisis to 5% last year and Spain has even managed to turn some long-standing deficits, such as those in trade with the European Union and in non-tourism services, into surplus. A large number of Spanish firms have remained in operation and in profit as a result of having undertaken rapid adjustment, although unfortunately this has almost always been achieved through the only channel permitted by our obsolete and inefficient labour market: staff layoffs.

Households, whose saving rate had fallen to 11%, reacted by swiftly raising it, which is enabling them to lower the rate in the present phase of the adjustment. At the same time we saw how non-energy inflation, which had been continuously far above that of our euro area partners since the creation of the single currency in 1999, fell substantially, to the extent that, in 2009 and 2010, its annual rate was under 1%, holding below that of the euro area. Finally, with regard to the banking sector, the rapid expansion of credit, which had reached a rate of 25% per annum and had been the most important source of excessive household and corporate indebtedness during the years of expansion, fell rapidly to stabilise at slightly negative levels over the past few years.

Some might say that all this was inevitable, that ten years of imbalances required a correction, and that is partly true. But if we compare with the adjustment observed in other countries in a similar situation, the reaction of the Spanish private sector has been notably swift. The results obtained by those firms that have survived and the behaviour of Spanish exports, which have grown faster than German exports during the three years of crisis, are examples of how the Spanish private sector is reacting positively to the challenge of the crisis.

And as I have said, all this has been achieved with a labour market that, unlike those in other more prosperous countries with greater social solidarity, forces firms to adjust through quantities. Thus, for the third time in thirty years, with the same institutional framework, our unemployment rate stands once again at over 20%. Nor should we overlook the damage to the productive fabric, which has occurred because so many firms have had to close owing to the lack of appropriate mechanisms allowing a flexible response to the crisis.

The development of the crisis highlighted the need for structural reforms in areas like the labour market, public spending and savings banks. Initially the progress made in fiscal consolidation was very modest, but the outbreak of the sovereign debt crisis a year ago marked a significant turning point in the economic policy stance. Since then, government and Parliament have adopted an ambitious raft of measures, with the drastic reduction in structural public spending being particularly notable. This has involved unpopular measures such as reducing the wages of public sector employees, freezing all pensions except for the minimum ones and sharply reducing public investment, as well as the recent agreement to improve the sustainability of our public pension system.

In relation to the banking sector, the government and Parliament initiated the reform process a year before the markets began to show signs of concern with the explosion of the sovereign debt crisis. Far-reaching measures were taken that enabled the principal problems of the sector to be tackled before they became intractable.

The main task undertaken to tackle the structural problems in our banking system has undoubtedly been the restructuring of the savings bank sector. Part of this sector had built up significant imbalances during the expansionary years. This, along with the duration and depth of the international economic crisis, made evident the need to create an instrument with considerable financial capacity and sufficient powers to carry out extensive restructuring of the savings bank sector. For this purpose, at the beginning of the summer of 2009 the Royal Decree-Law on the creation of the Fund for the Orderly Restructuring of the Banking Sector (the FROB) was approved, which would be ratified by Parliament one month later.

Since then, the restructuring of the sector, partly achieved with the assistance of FROB funds, has been of an extraordinary intensity. In less than two years, the 45 savings banks previously in place have been reduced to a third of that number, and the consolidation process has affected more than 95% of the total assets of the sector.

The objectives of this restructuring and integration process were very clear. First, to correct the excessive fragmentation of the sector. Indeed, the average size of the resulting institutions is two and a half times larger, which boosts their competitiveness and facilitates the raising of external funding. Second, to reduce the excess capacity in their branch networks and central services. The adjustment envisaged in the restructuring plans would involve a reduction of 10 to 25% in the number of branches and 12 to 18% in the number of employees. These cuts are in addition to those which had already been made previously, of 5% in branches and 4% in staff from their peak levels in 2008. However the ultimate objective of the integration processes was to strengthen the viability of the resulting institutions with the funds and management capacity of the savings banks best positioned to lead each of the integration processes, and to contribute to cleaning up savings banks' balance sheets. In fact, thanks to these processes, savings banks have recognised additional losses on their loans and receivables and foreclosed assets for more than €20 billion. Finally, the savings banks law was amended in an effort to increase the professionalism in the management of these institutions, and to open them up to market discipline and the possibility of raising share capital to strengthen their solvency.

In parallel with the restructuring of the savings banks, there has been a significant drive to clean up balance sheets in the Spanish banking sector and to ensure that assets are appropriately valued. As is well known, Spain's current system for valuing assets is highly demanding, both in terms of the criteria for classifying assets as troubled and in terms of provisioning and write-downs. One example would be the treatment of savings banks' exposure to the construction and real-estate development sector. The total amount of this exposure is €217 billion, of which 28 billion (13%) is made up of doubtful assets. That said, the requirements of the Banco de España force the banks to also record as potentially troubled investments, and make the necessary provisions for, assets acquired in payment of debt, as well as standard loans under surveillance owing to some observed weakness, even if payments are up to date.

As a result of these rigorous asset classification criteria, as at 31 December 2010 savings banks were obliged to recognise €100 billion of potentially troubled lending to construction and property development, i.e. 46% of their total loans and receivables in this sector. This gives an idea of the transparency efforts made, which have been far beyond those required in other parts of the world. Accumulated specific loan loss provisions represent 31% of these "extended" troubled assets, and if we add the general provisions this percentage reaches 38%. If we take into account the margin provided by the loan-to-value ratio and the fall in real estate prices that has already taken place, it would be necessary to make catastrophic assumptions, beyond all reasonable expectations, regarding the expected losses in order for the total losses to be well above the total volume of loan loss coverage.

Moreover, the Spanish system of specific provisioning has been tightened so that banks have an even greater incentive to speed up their balance sheet write-downs. Thus doubtful loans, once the value of the collateral has been taken into account, have to be fully provisioned within a period of one year. In addition, the value of collateral is subject to significant haircuts ranging from 20% for completed housing to 50% for land. Finally, the law requires provisions of up to 30% to be recorded for foreclosed assets that have remained on the balance sheet for two years. But perhaps the characteristic which makes Spanish provisioning regulations unusually strict is that the parameters determining the provisions are transparent and apply to all banks. Therefore, unlike in other countries, they are not left entirely to be negotiated between the bank and its external auditors.

It is not only legislators and regulators who have adopted measures to anticipate future problems. Spanish banks too, savings banks included, have made an enormous effort to clean up their balance sheets, something which is not always duly acknowledged in analyses of the Spanish banking system. In fact, adding up the net specific provisions made for loan losses since the beginning of 2008, the general provisions also used to cover impaired assets, and the charges to reserves by savings banks involved in the aforementioned restructuring processes, write-downs in the last three years by the Spanish banking system amount to about €96 billion, or around 9.5% of GDP. Moreover, in that same period, thanks to FROB resources, but also, especially, to the efforts by banks, the latter have increased the capital held in excess of minimum requirements by approximately €53 billion, or roughly 5% of GDP.

A key factor in the sector restructuring strategy has been the decision to increase the transparency of the Spanish banking system as much as possible. Whenever the general perception is more negative than the reality, the best policy is to present all the data clearly. For that reason the Banco de España announced last June that it would conduct stress tests, which it was later agreed should be carried out at the European level under the coordination of the CEBS. Although these tests were severely criticised after the collapse of some banks in other countries which had successfully passed them a few months earlier, the rigour and transparency of the exercise carried out by the Spanish supervisor must be emphasised. Demanding criteria were used and, unlike in other countries, all listed banks and savings banks were tested and much more detailed information on their portfolios was offered. The markets appreciated that effort and, after the summer, Spanish banks were again able to issue debt on the international wholesale markets.

However, Ireland's sovereign debt crisis again increased the strains on the government debt markets and a fresh lack of confidence in the Spanish banking sector and misgivings as to the quality of its assets resurfaced.

Those events highlighted the need for more rapid and far-reaching action to confront the difficulties facing a part of the Spanish banking system. Immediately, the Banco de España stepped up its transparency requirements for the asset portfolios on which doubts centred. Thus early this year all savings banks were obliged to make public their exposure to the real estate development sector, their doubtful assets, their standard exposures under surveillance and their provisioning levels, and to specify the type of collateral securing those exposures. Also, they were asked to publish information on their foreclosed assets and on their exposure to households through residential mortgages so that, although this is not an area of concern, the market could distinguish between risks which at times – unjustifiably – it treated similarly.

Further to the recently ratified Royal Decree-Law, the Spanish Parliament has taken an additional step to strengthen bank solvency. Happily, it was understood that, while important, what had been achieved thus far was not sufficient and that it was necessary to take further measures to hasten the restructuring process. The markets' reaction has demonstrated that the Royal Decree-Law has been most effective in restoring confidence in the Spanish banking system and has ushered in a new stage in the process of savings bank restructuring, adding to the progress of recent years in cleaning up balance sheets and reducing the sector's capacity and fragmentation.

The Royal Decree-Law has some very specific aims. The first is to strengthen the solvency of all Spanish banks, setting a level of core capital of at least 8%. Also, given that investors' misgivings centred on a small group of unlisted banks with a greater dependence on the wholesale market, it was decided to require those banks to hold core capital of 10%. Additionally, the Royal Decree-Law stipulates that credit institutions needing government funds will have to pursue their financial activity through a commercial bank. This measure speeds up the strategy followed so far. Savings banks that have to increase their level of core capital may raise that capital on the market through the commercial banks which, in most cases, they have created and started up since the end of last year. Investors now have highly granular information on the portfolios of these banks, which moreover will be audited and published shortly.

Sometimes it is alleged that the injection of capital into the savings banks has come late and that Spain should have followed the example of other countries which injected huge amounts of public funds into their major banks immediately after the Lehman crisis. That would have been a mistake as the problems were different. Spain's task was fortunately not to urgently recapitalise its large banks, which were indeed collapsing in other countries owing to deficient regulation and supervision. The unavoidable issue here was to oblige certain small and medium-sized institutions removed from market discipline – the savings banks – to restructure, after they had lent in excess to the real estate sector. In Spain, rather than recapitalising, it was vital to restructure these banks and clean up their balance sheets. To have recapitalised banks before cleaning up their balance sheets would have been to waste public funds, without having achieved changes in management or capacity reductions, which are essential for the soundness of the income statements of the surviving banks.

What is clear now is that the reform of the governance of savings banks and their subjection to market transparency and discipline should have been carried out sooner, in the boom rather than in the crisis. The banking crisis management legislation then in place, which was of no use for addressing non-commercial institutions and was not adapted to the requirements of the European legal framework, which prohibits monetary financing, should also have been amended at that time. These banking reforms, like all the others now under way (on public spending, pensions and the labour market), should surely have been carried out during the years of expansion, when everything seemed to be going well and the problems that would eventually surface because of the imbalances that were building up were blithely ignored. Unquestionably, we would not now be facing the problems then being incubated and which have now emerged with the crisis.

Regarding what has been done so far, it would be unfair not to mention the contribution of the EU authorities, since although there were initially some serious communication and coordination problems, the fact is that subsequently they took appropriate measures aimed at imposing greater economic discipline and improving confidence, such as the reform of economic governance and the Stability and Growth Pact and the recent "Pact for the Euro". And, of course we cannot overlook the ECB's contribution with its policy of providing unlimited liquidity and its programmes to purchase covered bonds and the government bonds of the countries hit hardest by the crisis.

In short, at this stage it can now be said that both the authorities and private agents have made considerable efforts in the right direction and that, as a result, the process of adjustment of the banking sector and of the Spanish economy as a whole is progressing reasonably well.

The challenges ahead

It is clear from the foregoing review of events that at a time like the present we cannot become complacent because there is still a long path ahead.

In the banking sector, it is necessary to complete the process of recapitalisation and adoption of new organisational structures envisaged in the February Royal Decree-Law.

The Royal Decree-Law, which increases the capital requirements of Spanish banks, also promotes the raising of private capital and sets the timetable for recapitalisation of the banks that fail to reach the levels of capital required by the new legislation.

Of the 114 groups or individual institutions (commercial banks, savings banks and credit cooperatives) that the Banco de España examined pursuant to the Royal Decree-Law, in more than 100 cases it concluded that there was no need for more capital. Accordingly, the great majority of Spanish institutions satisfied these exacting requirements. In twelve cases it was determined that additional contributions of capital were necessary to comply with the provisions of the new legislation. In one of these projects, the institutions that make it up have decided to go their separate ways, while in the other eleven cases there have been no incidents of note to date. Therefore, the Banco de España will probably have to analyse thirteen rather than twelve recapitalisation plans.

Last week the banks submitted their strategies for complying with the new capitalisation requirements. The Banco de España has to approve or, where appropriate, require the necessary changes to be made to these plans, which must be implemented by 30 September, although the Banco de España may grant an extension of this deadline in the cases specified in the Royal Decree-Law.

It is important to stress that the FROB is obliged to contribute the necessary capital to the banks which request it, as either a first or a subsequent option, to supplement or replace private capital. This contribution of government funds does not constitute, as some have argued, a nationalisation of banks, but rather exceptional and temporary support, since the

FROB funds must be repaid or replaced by private capital as required by the Royal Decree-Law. The participation of the FROB in this process enables an orderly entry of private investment in the savings bank sector. But what has been most effective to improve market confidence has been the very existence of the FROB as a backstop, assuring investors and lenders that, from the entry into force of the Royal Decree-Law, all Spanish banks are, de facto, operating with levels of core capital exceeding 8–10%.

The entry of private capital will require savings banks to undertake a definitive and clear professionalisation of their management. This requirement is fortunate because it is a necessary condition for preventing a repeat of past events. Thus it is not only the regional authorities who must avoid any action which may deflect banks from their essential objective of serving households and firms; also, those who are now at the helm of savings banks must hasten the reform of their corporate governance because very likely the market will not lend again to anyone unable to give it an assurance of professionalism and corporate governance on a par with that of commercial banks.

Going back to the economy, we must be patient. Immediately ahead of us, the adjustment phase will continue. True, there has been a notable correction in some of the main imbalances in recent years. But it is still too early to say that the Spanish economy is at a stage where it can once again resume robust growth. Further effort will be needed to digest the excesses of the housing boom, and it will be some time before net job creation gains momentum, unless ambitious reforms are implemented. The structural reforms launched in the past year represent positive progress. At present it is essential to persevere with these measures – such as the fiscal consolidation process – and maintain the pace of reform, tackling the reforms needed in areas which are essential for competitiveness and for boosting the Spanish economy's potential growth.

The key issue now is not to stop, but to push ahead with the reforms, with all of them, including of course the restructuring of the savings banks, which has been the subject of my speech. But most important, due to it being an area which sets us furthest apart from other developed countries, is the reform of the labour market institutions which are the cause of the our economy's main problem. Our labour market framework makes us unique in comparison with other countries: it hampers job creation and encourages the use of job destruction as a mechanism for adjustment.

Here it will not be enough, when the reform has been passed, to say "it's a move in the right direction". In this connection, not only the *direction* but also the *scale* of the reform is important. Yet we would surely not have to go very far. It would suffice for employers in Spain to be able, as in other developed countries, to offer jobs with productivity-based wages to the millions who are unemployed and for the latter to have the possibility of considering job offers that Spanish employers can't even make to them due to the inflexibility of our singular regulations.

Reducing unemployment and increasing employment is not only an indispensable social goal but it is a vital economic target at this juncture. If we manage to bring the labour market framework more into line with that of our European partners, there will be a swifter and stronger recovery in employment. And that would have effects that go beyond the obvious increase in the welfare of the workers, such as making it easier to restore health to public finances and reducing defaults, which would encourage lending.

In this context, 2011 will remain a difficult year for almost all economic agents, especially for Spanish banks, which must strive to defend their bottom line. Their net interest income will come under pressure from the stagnation of business volumes and the increase in financing costs, although, to qualify this, the pass-through of higher marginal rates to average margins is relatively slow. Furthermore, despite the substantial efforts made, the Banco de España's provisioning rules will continue to compel banks to carry on recording provisions to restructure their assets. Against this backdrop, banks must counter the negative pressure on profitability through cost containment, especially in those banks involved in restructuring processes.

Banks will continue to suffer from the flatness of their main line of business, namely lending. Solvent demand will remain low and, if credit usually only recovers at the end of an adjustment phase, in the Spanish case, since households and corporations have to reduce their debt, solvent demand for credit can be expected all the more to take longer to grow. Given this outlook, it is most important that the banking sector is ready to provide credit when the related solvent demand recovers in parallel with the improvement in the situation of corporations and households. Accordingly, the restructuring measures adopted to date have prevented the survival of zombie banks which, were it not for their integration into the best banks, would have ultimately proven useless for providing credit. Along the same lines, since the recently approved Royal Decree-Law reacted in time to the huge distrust triggered by the crisis in Ireland, it headed off the sharp credit crunch that would have occurred as a result of the vast majority of Spanish banks being locked out of the markets.

Most projections point to a stronger economic recovery in the second half of 2012 and in subsequent years. And this scenario should be strengthened by the effects of the structural reforms. This more favourable environment, together with synergies, cost cutting and increased efficiency associated with the completion of the savings bank integration and restructuring processes and the reduction of surplus capacity in the sector, should contribute to shaping a more positive scenario for the profitability of the Spanish banking sector.

Conclusion

Let me conclude by reiterating that there are grounds for us to be hopeful and patiently optimistic subject to certain conditions. Indeed, during the latest phase all the agents involved – government, Parliament, the European authorities, the ECB, the Banco de España and the banks – have moved in the right direction, and this has had its reflection in market perceptions in recent weeks.

However, market confidence *è mobile*; it can be easily lost and, therefore, we must not be complacent. We are on the right path to emerging successfully, and even strengthened, from the difficulties that have affected our economy and banking system. But, for this to happen, it is essential for the reforms to continue and for them to remain ambitious. Consequently, our optimism can only be conditional upon the continuation of the reforms.

Finally, we must be patiently optimistic not only with the reforms, which need to be accelerated as much as possible, but also with their results. 2011 will continue to be another year of adjustment and it will even be one of the hardest years for the banking system. It is said that some marathon runners hit a “wall” in the final miles of the race. Even though they have completed most of the race, the finishing line seems far off to them and they need great mental fortitude not to give up. We, too, should ensure that the adjustment process and reform of the Spanish economy does not hit any “walls”. During the recession to date there has been a highly substantial correction in the real economy and in the banking sector, but now we need patience and perseverance to successfully conclude this process.

Thank you very much