

Miguel Fernández Ordóñez: Recent decisions adopted by the Bank of Spain

Testimony of Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, before the Parliamentary Committee on Financial Affairs, Madrid, 2 April 2009.

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Honourable Members of Parliament,

Let me begin this testimony by thanking you for the opportunity to explain the recent decisions adopted by the Banco de España as supervisor of the banking system in relation to Caja de Ahorros de Castilla La Mancha (CCM).

Last Saturday, the Executive Commission of the Banco de España adopted the decision to replace the governing bodies of the institution with three provisional central bank nominees. On Sunday, 29 March 2009, the government, in an extraordinary meeting of the Council of Ministers, passed a Royal Decree-Law authorising guarantees by the Treasury for a maximum amount of €9 billion backing the loan the Banco de España could grant to CCM. These two decisions have allowed CCM to continue operating normally and to meet all its payment obligations and commitments.

This solution was adopted once a "private" solution to CCM's problems under the Savings Bank Deposit Guarantee Fund had been deemed inviable. As you know, CCM has held talks (exploratory in some cases, more advanced in others) with other savings banks with a view to participating in a merger process giving rise to a new economically and financially viable institution. In this connection, assistance from the Savings Bank Deposit Guarantee Fund had been envisaged to smooth the process. The talks between the interested parties themselves and with the Fund did not however prosper. Accordingly, the Banco de España took action to avoid a crisis of confidence in CCM and market convulsion.

On this point I should like to draw your attention to the reasons for adopting this decision with such urgency. Article 31 of the Law on the Discipline and Intervention of Credit Institutions authorises the Banco de España to take control of a credit institution or to resolve to replace provisionally its governing and management bodies when there is a situation endangering its own funds or its stability, solvency or liquidity.

Since the directors of CCM had been unable to find a solution to prevent the problems worsening, it did not seem reasonable to delay the use of the precautionary measures provided for in the Law on the Discipline and Intervention of Credit Institutions in order to seek other solutions.

Further, once the prospect of a merger had fallen through, there was an evident risk that, once the financial markets opened on Monday, 30 March, CCM would be subject to a crisis of confidence on the bond markets and further withdrawals of deposits from its branch network that could prompt a liquidity collapse.

The delicate situation of CCM required the immediate activation by the Banco de España of the precautionary measure provided for in the rules governing the replacement of the Board and the appointment of new managers. To speed the process and avoid unnecessary delays that might exacerbate liquidity problems, and to halt any possible contagion to other parts of the system, the Banco de España took the swiftest of decisions while fully observing the provisions of the Law on the Discipline and Intervention of Credit Institutions.

The conduct of the Banco de España has been informed by the lessons that all supervisors have drawn from the unfolding of the financial crisis in other developed countries. In particular, it is our resolve to prevent the problems of an individual credit institution degenerating to such an extent as to spread to other domestic banks and savings banks.

The speed behind the Banco de España's decision also justifies the urgency of and need for the Royal Decree-Law adopted by the government. Without going into details on the legislation, I would like to stress that the granting of guarantees by the Treasury has a dual purpose.

First, it allows the Banco de España to act with full force, providing a very high volume of guarantees backing potentially significant funding. Such provision is necessary if the ailing credit institution is to meet all its commitments and honour all its payments. Since autumn 2008, when the suspension of payments by Lehman Brothers led to a risk of widespread collapse on the international financial markets, no country has allowed any credit institution active on international markets to suspend payments. Spain has followed the lead of the developed countries, and you should rest assured that CCM will meet all its commitments to depositors and other creditors.

Second, the Maastricht Treaty prevents central banks from extending emergency liquidity assistance to an ailing institution, such as CCM, without the appropriate collateral. Given the amounts that might have to be committed, the Spanish Treasury had to provide explicit guarantees to the central bank, so as not to infringe the Treaty's prohibition on central banks extending "monetary financing" to public Treasuries.

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Having explained the substance of and the reasons behind the urgent replacement of CCM's directors, allow me to offer greater details on the Banco de España's past supervisory measures in relation to CCM and its current situation. Before that, however, I should highlight what is a primordial starting point: CCM is a credit institution with a positive net worth. That is to say, and in the vernacular of the press, the institution has no "hole" in its balance sheet.

Yet this does not mean it is not facing serious problems, the cause of which must be sought in an inappropriate management of risk and a forceful business expansion – especially in the real estate sector – funded largely through resort to the international bond markets, generating sizable imbalances. Past experience shows that these credit expansion policies are very dangerous if unaccompanied by the related risk control measures since, generally, they usually entail a relaxing of credit standards. Responsibility for these decisions falls on CCM's previous directors.

Given CCM's problems, the Banco de España's supervisors had considered the institution worthy of "special monitoring". That justifies the constant vigilance of developments in CCM's risks, solvency, profitability and liquidity, since it was considered to be particularly vulnerable to a downturn in the business cycle and, in particular, in the real estate market. In the past year, CCM was subject to two inspections, with the second review based on year-end figures for 2008 currently drawing to a close.

Allow me to focus on the recommendations made by the central bank in its supervisory capacity in recent years. Back in 2003, the recommendations detailed further to inspection called on CCM's directors, as was the case at other institutions, to reflect on the amounts assigned to funding real estate development activity, owing to the high risk this entailed. These concerns were taken into account in the ongoing monitoring of the institution and were reiterated in the letter of requirements following the first inspection carried out in 2008. These requirements referred to a sizeable volume of exposures in which some degree of impairment or weakness was apparent, denoting a deterioration in the quality of lending, which was accounted for by the global financial crisis and its impact on developments in the real estate sector and by other specific factors. The letter of requirements urged the Board of Directors to analyse risk policies and decisions, and to urgently apply the measures needed for a more effective management of bad debts, demanding as at that date an increase in write-downs.

All these recommendations and requirements simply reflected the Supervisor's concern about credit-expansion and risk-management policies. Accordingly, in July 2008, CCM was

required to draft a report on future business plans and a strategic assessment of its position as at that time. This report, along with the Supervisor's conclusions further to the inspection in the first half of 2008, highlighted the need for CCM to find a solution that would ensure its future viability, preferably by merging with another savings bank.

This message was officially communicated to the senior management of CCM at the beginning of October 2008. They began the search for an institution interested in merging with CCM. The failure of these negotiations is what finally prompted the decision taken last weekend.

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CCM was formed in 1992 as a result of a merger of various savings banks in the region. It currently has a balance sheet exceeding €26 billion (representing approximately 0.8% of total Spanish financial system assets) and about 3,200 employees and 600 branches.

As regards solvency, as at 31 December 2008 the institution had positive net worth for accounting purposes (i.e. net assets exceeding debts), even after recording the adjustments estimated in the inspection which is now being completed. These adjustments mean that the institution will incur a significant loss for the year, but one which is far from the figures being publicly aired. That said, I do not wish to suggest that CCM has an adequate regulatory profile, since from a prudential standpoint it does not meet the minimum regulatory capital requirements.

Allow me to clarify this point further. As you know, Spanish solvency law (which adopts the EU rules known as Basel II) requires credit institutions to observe a minimum capital ratio of 8% of their risk-adjusted assets. The institution, with a level below 8%, does not currently meet this requirement. However, this does not mean that it is insolvent or that its net assets are insufficient to meet its liabilities.

Part of this non-compliance with the capital ratio is due to the growing provisions for loan impairment and to the large losses on its portfolio of corporate holdings and financial investments, which had a negative impact on its income statement. The analysis currently being completed by the Supervisor and CCM's external auditors, which is based on data relating to end-2008, allows us to predict that CCM will post a significant loss in its consolidated financial statements for 2008. This changes the projections issued by its former directors.

Indeed, the former directors should have submitted the final accounts for 2008 at the board meeting scheduled for Tuesday, 31 March. The replacement by the Banco de España of the board of directors the previous weekend caused that submission to be postponed while the new provisional central bank appointees receive the latest reports from the audit firm and the Supervisor.

These events, along with the reversal of certain losses previously charged to equity and the effect of these adjustments on the corporate income tax charge, mean that we can anticipate a notable decrease in net worth, which, however, will remain positive.

In sum, I have to inform you that the final adjustment figures are not yet available. Nonetheless, I can assure you that they are substantially lower than some of the figures that we have heard in the last few days. Also, the submission of the annual accounts by the provisional central bank nominees has been postponed in application of the powers established in Article 36.2 of Law 26/1988 of 29 July 1988 on the Discipline and Intervention of Credit Institutions, since it has been considered preferable to await the conclusions reached in the inspection now drawing to a close.

With regard to liquidity, the turmoil of the last few months put CCM in a difficult position:

- Wholesale financial market tensions and the downgrading of CCM's credit rating closed the door to institutional funds. This lack of access to funding via wholesale

markets was particularly painful for it, as it had resorted extensively to this source of funds for its business expansion plans.

- The institution's gradual deterioration was common knowledge and increasingly the subject of political and media discussion. This adverse publicity gave rise to a drain on deposits.

In view of this delicate situation and since the problem is a pressing one, the Banco de España, with the Government's agreement, decided it was necessary to provide additional financing to CCM to preserve its stability. To this end, the Government granted backing to the loan, for a maximum amount of €9 billion, extended by the Banco de España.

I would like to underscore this point. As reiterated by the Second Deputy Prime Minister at the press conference following the meeting of the Council of Ministers last Sunday, I should stress that we forecast that approximately €3 billion of this amount will be used. Nevertheless, our room for manoeuvre will make managing the payments more flexible, without any constraints in respect of the amounts involved.

Developments in CCM's liquidity in the three days it has been under the control of the Banco de España nominees have proven more positive than expected. Given the response by all the government authorities involved, management cooperation, the reaction of the trade unions and understanding on the part of the general public, there have been no queues or panic at branches and there have clearly been fewer withdrawals of deposits than foreseen.

Having briefly outlined CCM's current position, let me move on to the ultimate aim of the Banco de España's supervisory decisions.

While seemingly obvious, the Supervisor's aims are to protect depositors' savings and creditors, to avoid market turmoil and to preserve the stability of the financial system as a whole. The objective of the central bank's control is to stabilise CCM, to avoid a liquidity collapse and to manage the institution for as short a time as possible with a view to finding an orderly solution.

Ultimately, the viability of CCM's future business may be achieved in different ways (for example, through a merger with other credit institutions), with the Banco de España currently not ruling out any options. The response to these options will be swift, but not immediate, and will require the collaboration of authorities, financial institutions, employees and creditors.

I would not like to forgo the opportunity of appearing before this Committee without highlighting some of the messages recently conveyed by the Banco de España.

Firstly, I would like to reiterate that involving savings banks in the political debate makes it immensely difficult to find flexible and effective solutions. Opinions become distorted, suspicions, demands and expectations of the parties involved grow and solutions become increasingly complicated. We should not forget that past experience in Spain and abroad shows that prudence and discretion are prerequisites for reducing the costs of possible solutions for troubled institutions. Otherwise, we will make the authorities work more difficult and, ultimately, taxpayers will pay a higher price.

In finding a solution to the difficulties encountered by CCM, the Banco de España has adhered to its tradition of adopting decisions based solely on the objectives of preserving the stability of our financial system, minimising the cost in terms of public funds and maintaining the availability of sufficient financial services. To conclude, I have personally conveyed to the Government and to the main opposition party the need for certain regulatory changes that might notably improve finding solutions in keeping with the principles informing our actions to date, which as you are well aware, were backed by a recently approved parliamentary motion.

The purpose of my testimony today is not to debate what must be done in future, since that is evidently the primary responsibility of the Government and the parliamentary groups, since

any changes must ultimately be approved by this House. However, I do want to mention some changes which we would view very favourably. For example, providing savings banks with the wherewithal to increase their own funds, at least on a comparable footing with Banks. This is important because, as I have reiterated today, it is essential to consider all possible private solutions before asking taxpayers to contribute more public funds. Evidently we must comply with the requirements of Monetary Union membership. But in this connection, one desirable institutional change, along the lines of the deposit guarantee funds that have worked so well for us, would be to avoid, as has occurred in the case of CCM, calling a cabinet meeting every time taking control of an institution is called for. These and other changes should also strive to ensure the orderly restructuring of banking institutions and, while maintaining the necessary discretion specific procedures require, comply with all government and parliamentary reporting procedures deemed necessary.

Thank you very much.