Economic Watch

Financial Systems

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Economic Analysis

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Effect of second ECB auction on Spanish banks

- Spanish banks increased substantially their share of ECB funding (which stood at 38% before the latest long-term auction), as they could have borrowed around €100bn in this operation.
- Liquidity worries have declined: 2012 maturities of wholesale market funding are no longer an issue, but funding remains a matter of concern. With this operation, Spanish banks have concentrated their sources of funding and they will have to repay all the liquidity borrowed between December 2014 and February 2015.
- Possible uses: With this liquidity, banks could decide replacing short term financing by medium term funding, creating liquidity buffers, buying sovereign bonds, buying own debt and/or lending to the real economy.
- Liquidity funding remains disfunctional: To improve bank funding conditions at the European level it would be key to open the bank bond issuance (preferably the unsecured bond segment), perhaps using guarantees to bond issuance. Reducing even further remuneration at the ECB's deposit facility or even penalizing banks to store liquidity there would also help.
- In Spain "forcing" entities to tap the market when they use public guarantees and pushing for a transparent restructuring of the sector, so that investors are well informed and can distinguish between entities, is the route to follow.

1. Spanish banks increased substantially their share of ECB funding

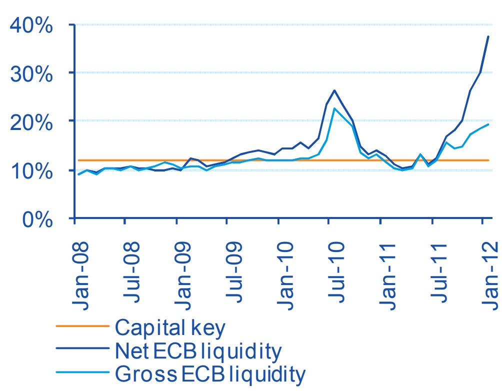
On 29 February the ECB performed the second 3y LTRO. The gross funds raised for the whole European system were €529.5bn, while the net funds borrowed were €314bn. It is not public the breakdown by country.

Assuming that the share of ECB funds borrowed by the Spanish financial system is maintained at the January 2012 level (20% of total gross funds, not deducting the deposits facility), we estimate that Spanish banks could have borrowed around €100bn in this auction.

The recent increase in the gap between the gross and net amount (see chart below) indicates that since the last quarter of 2011, Spanish banks have placed in the ECB a much smaller proportion of funds than banks in other systems. As Spanish banks have not used the deposit facility as much as other banks, their share in terms of net funds increased much more than in terms of gross funds. As of January 2012, Spanish banks had a share of 37.8% of ECB net funds, the highest ever, versus a 20% share in terms of gross funds.

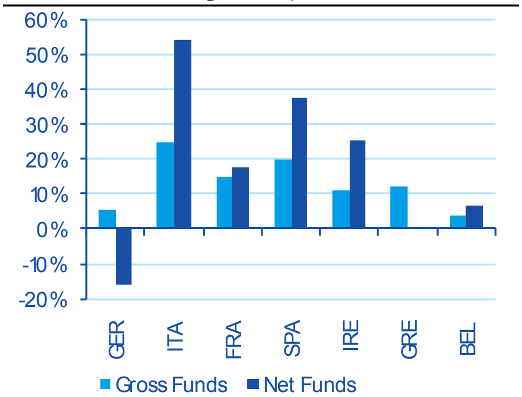
We should expect the share of net funds to go down after the recent auction, as Spanish banks should have higher liquidity buffers and are likely to use more the deposit facility at the ECB. We could put it this way: In December Spanish banks really needed the money while now, at least part of the banks, have ECB liquidity for precautionary measures. We can see in the chart on the right-hand side below that Italy, Spain and Ireland account for more than 100% of ECB net funds.

Chart 1
ECB liquidity (%total)



Source: BBVA Research based on ECB

Chart 2
Share of ECB Funding January 2012

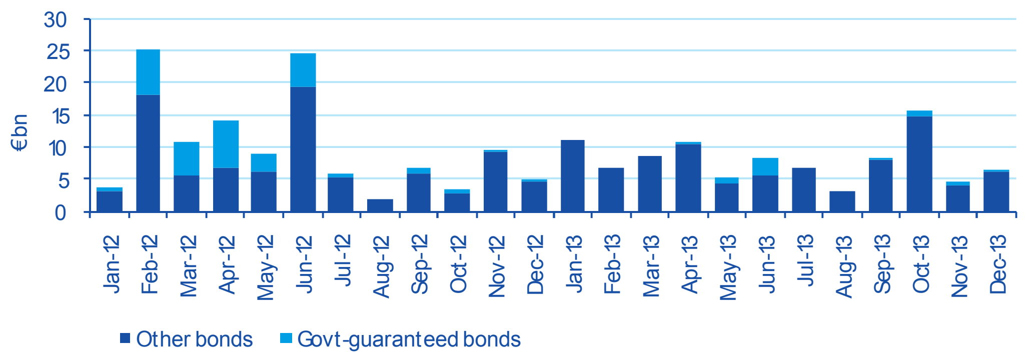


Source: BBVA Research based on ECB

2. 2012 Maturities of wholesale market funding are no longer an issue

According to Dealogic, Spanish banks' bond maturities in 2012 and 2013 amount to €120 bn and €96bn, respectively. If we take into account the excess liquidity placed at the ECB at the end of January - €28 bn - together with the estimated borrowed amount in the second auction - €100 bn -, it seems very plausible that Spanish banks will not have problems in attending all 2012 maturities.

Chart 3
Monthly maturities of Spanish banks' debt



Source: BBVA Research based on Dealogic

In annex 1, there is a table with Spanish banks that have publicly announced the amounts borrowed at the ECB and the comparison with wholesale funding maturities in the next years.

Liquidity risk for Spanish banks reduced considerably with the two ECB operations. At aggregate level, in the short term, liquidity is not a problem. At individual level, it is very likely that liquidity is not a problem either. For those entities that had not sufficient collateral, they had the possibility of issuing government guaranteed debt and retaining the bonds to pledge with the ECB. The public guarantees program was recently renewed for a maximum amount of €100bn. So far, in 2012, banks issued €23.7 billion of these public guarantees. Institutions with internal rating models could also benefit from the new ECB collateral rules, as certain loans to corporates with high internal rating are also admitted. Therefore, given current market conditions, it is difficult to believe that institutions with liquidity problems did not take the opportunity to get from the ECB all the liquidity needed.

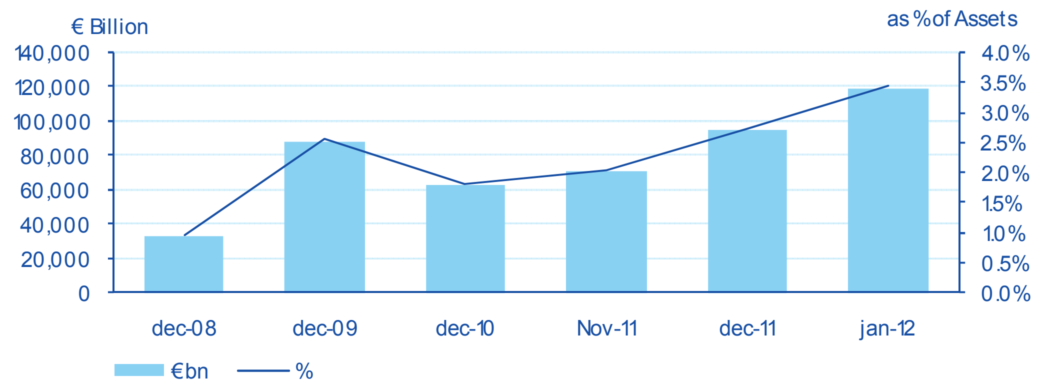
3. So, is liquidity no longer an issue? What about funding?

As mentioned above, the Spanish system should not have liquidity problems in 2012. In addition, there is no longer a 'stigma effect' associated to resorting to the ECB. However, funding remains a big issue. With this operation, Spanish banks have concentrated their sources of funding, putting all the eggs in the same basket. It is a concentration in terms of lender– the ECB -, of instrument and a potential problematic concentration of maturities in a very short period, as banks will have to repay all the liquidity borrowed between December 2014 and February 2015. They have the option of early repayment in one year, but unless market conditions improve significantly, it is difficult to envisage banks changing cheap funding by expensive one. Also, the deposits to credits gap is decreasing only slightly, so banks need to make this ratio more sustainable. We can end up with banks being complacent towards liquidity and towards funding, while they should fight for having access to the market and have a diversified funding structure, by instrument, maturities, geography and investors base.

4. What are banks going to do with ECB funding?

- Replacing short term by medium term funding. The amount borrowed by Spanish banks under MRO went down to €6bn in January 2012 from €54bn in November 2011, clearly indicating that banks are replacing short-term ECB funding by 3yrs funding. This is very positive and definitely improves their liquidity profile.
- Creating liquidity buffers, as exemplified by the increase in the amount of deposits placed with the ECB (€28bn in January 2012 up from €8bn in November 2011). This also improves the liquidity profile but with a cost in terms of margin.
- Buying sovereign bonds. Since November, the exposure to Spanish sovereign bonds increased by €50bn to €119bn at the end of January. For the banking system this is clearly positive in terms of margins. However, it also encompasses some risks. Banks are increasing their market risk exposure (with potential volatility in terms of capital) and are more vulnerable to the fate of the sovereign and EBA's future decisions on market-priced sovereign risk on the capital buffer. Indeed, northern European banks and German banks have decreased their exposure to European sovereign bonds in the last couple of months, which could still indicate lack of confidence in peripheral countries, or uncertainty on regulatory burdens.

Chart 4
Exposure of Spanish banks to Spanish sovereign bonds



Source: BBVA Research based on Spanish Treasury

- Buying own debt. Banks with excess liquidity are likely to continue to buy back debt, which is trading at significant discount, book a profit and increase capital.
- What about lending to the real economy? If banks have liquidity buffers they are in conditions to lend to solvent demand. However, given the macroeconomic scenario for Spain, with GDP contracting this year, and the high credit to deposits ratios that some institutions show, it is likely that banks continue to be cautious in their lending decisions; not to mention the need for a gradual deleveraging process.

5. Conclusion - next steps

The introduction of the three-year liquidity auctions has improved the liquidity profile of the Spanish financial system in the short term. The main shortcoming of this measure is that it may reduce the incentives for the system to actively look for funding alternatives. Banks should not be complacent and ignore that this is a temporary and unconventional measure and that it is not the role of the ECB to intermediate interbank flows.

To improve funding conditions for Spanish banks, we can distinguish two sets of possible measures:

a) European level

- Provide European guarantees to bond issuance – eliminates counterparty risk and the stigma of belonging to a certain European country or the ECB launching a purchase programme of senior bonds.
- Penalise banks for using the deposit facility at the ECB - could lead to a gradual re-opening of the interbank market, as banks could find more attractive to lend to each other than placing excess liquidity at the ECB.

b) National level

- Continue the ongoing restructuring in the Spanish financial system: evaluate thoroughly the capitalization plans that will be presented to the Bank of Spain by the end of March and find a definitive solution for the institutions which are not viable.
- "Force" banks to tap the market. Banks that issue government guaranteed debt should be incentivised to sell those bonds in the market. Public guarantees should be used to facilitate market issuing and not as a way to obtain liquidity from the ECB in order to buy additional time to sort out problems, particularly for those entities that are not viable. It would be desirable to give incentives for market issuing, considering it as a best practice.

Annex 1

Table 1
Comparison of wholesale maturities of some Spanish banks with funding raised at the ECB

	SPANISH BANKS					
	Maturities of wholesale debt				Funding from ECB	
	2012	2013	2014	TOTAL	Dec 2011	Feb2012
CAIXABANK SA	6,754	6,360	8,118	21,232	12400	n/a
BBVA SA	10,429	22,279	14,373	47,081	11,000	11,000
BANCO SANTANDER SA	27,541	29,077	24,523	81,141	n/a	n/a
BANKIA SA	25,000	5,972	8,919	39,891	15,000	25,000
BANCA CÍVICA SA	2,145	395	206	2,746	3,700	6,100
BANCO SABADELL SA	4,198	3,800	3,300	11,298	4,000	4,000

Source: Dealogic and BBVA Research

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