

The Spanish Financial System: A restructuring that has not finished

15 November 2011

Key themes

- **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.

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1. Spanish financial system: an European comparison
2. The problems of the Spanish financial system:
 - Solvency
 - Liquidity
 - Overcapacity
3. Next steps

Section 1

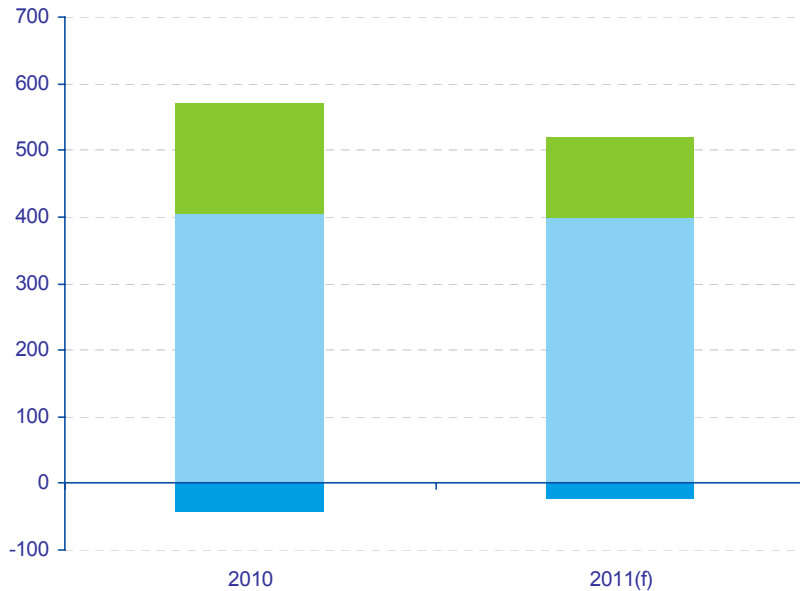
How has Spain funded its growth?

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)

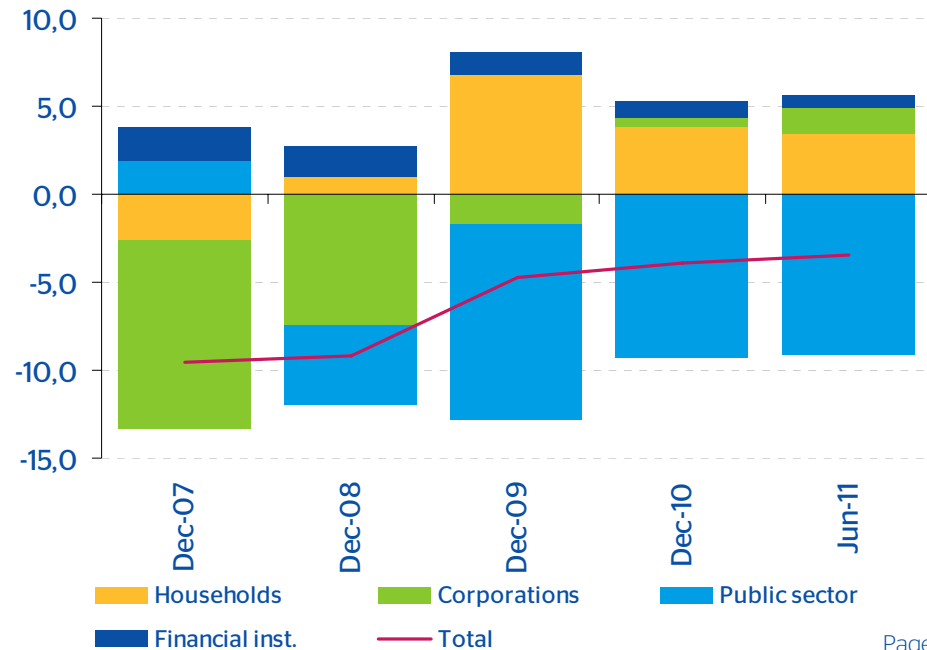
Source: BBVA Research based on Bank of Spain



■ Households and Corporates ■ Financial Institutions ■ Public Sector

Spain: External funding capacity (EUR bn)

Source: BBVA Research based on Bank of Spain



Section 1

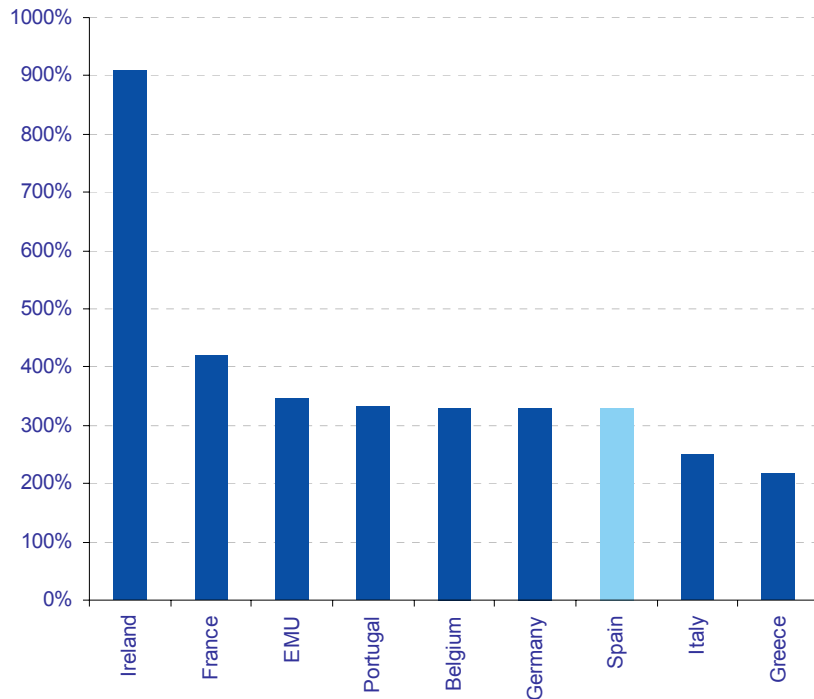
How has Spain funded its growth?

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)

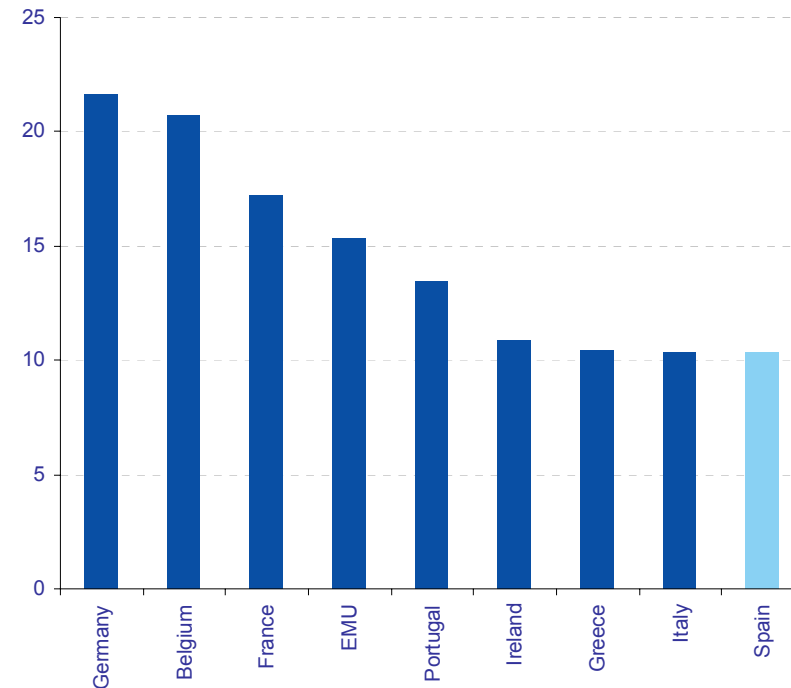
Source: BBVA Research based on Bank of Spain and IMF



Leverage of the Banking System: Assets/Capital and Reserves

(%, Sep-11)

Source: BBVA Research based on Bank of Spain



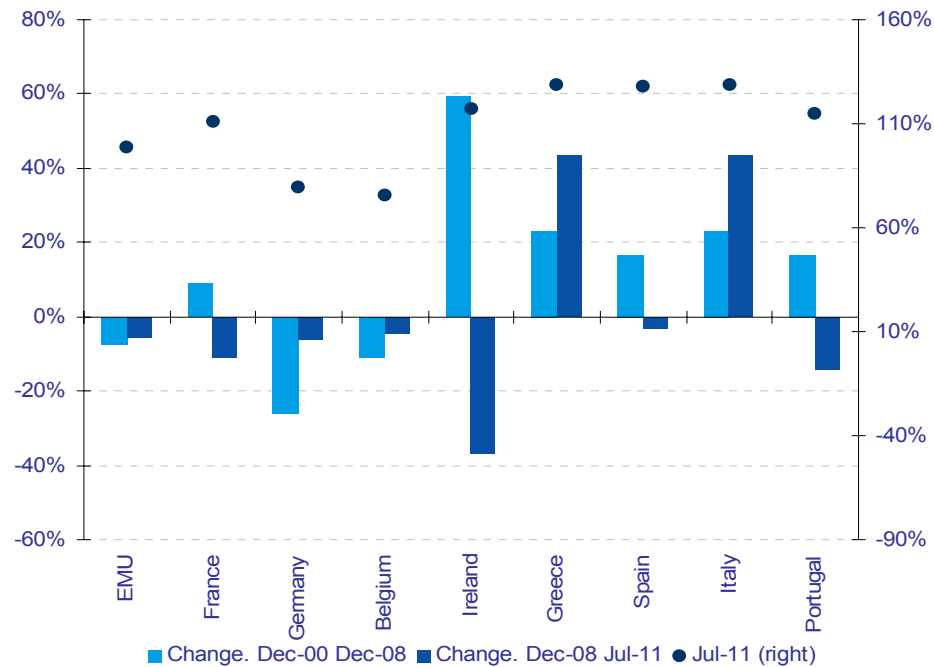
Section 1

How has Spain funded its growth?

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

Credit/deposits to the private sector

Source: BBVA Research based on ECB and national sources



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

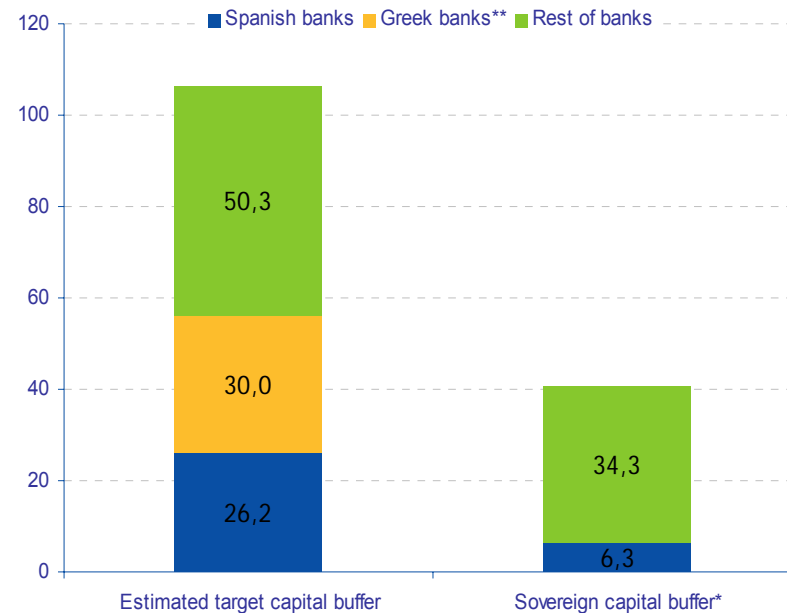
According to the most recent capitalization demands, a high proportion of the European capital needs corresponds to the Spanish banking system.

Why?

Does it make sense?

Estimated capital target buffers (EUR bn)

Source: EBA



* 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.

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

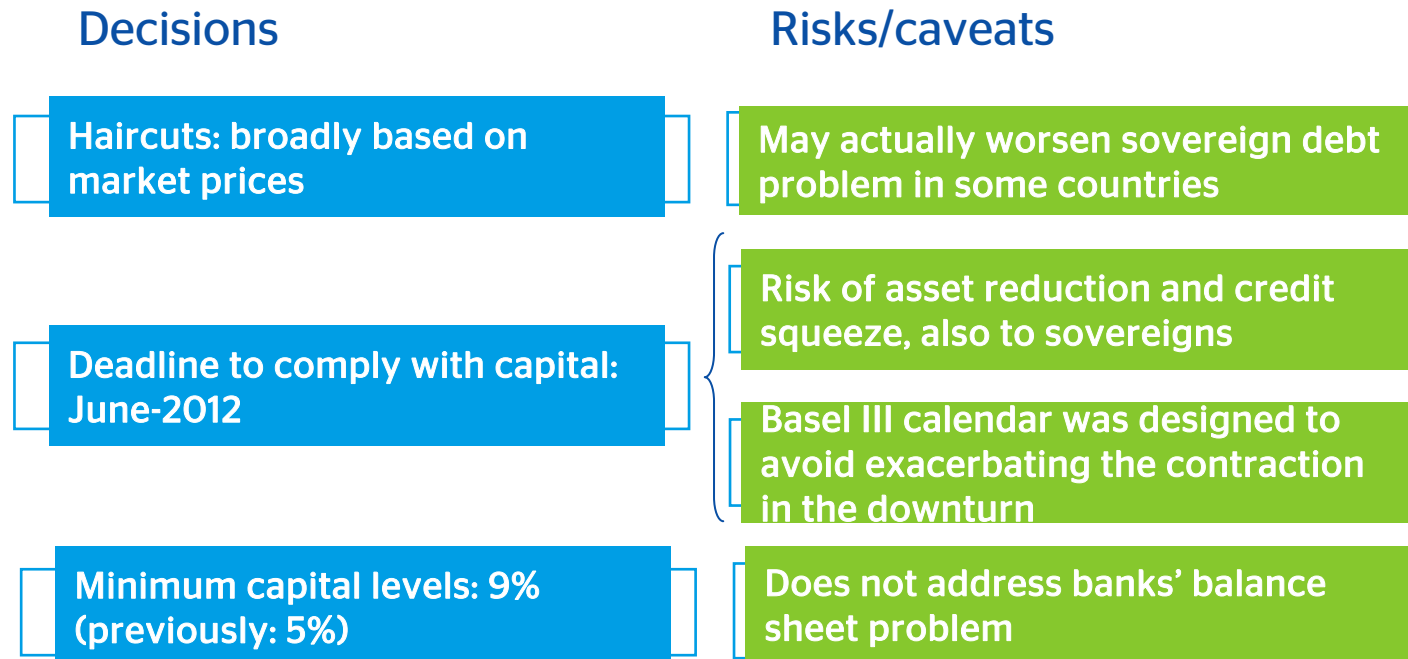
“In order to cover a hole with sand, we should first measure the size of the hole before putting together a huge amount of sand”

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.



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

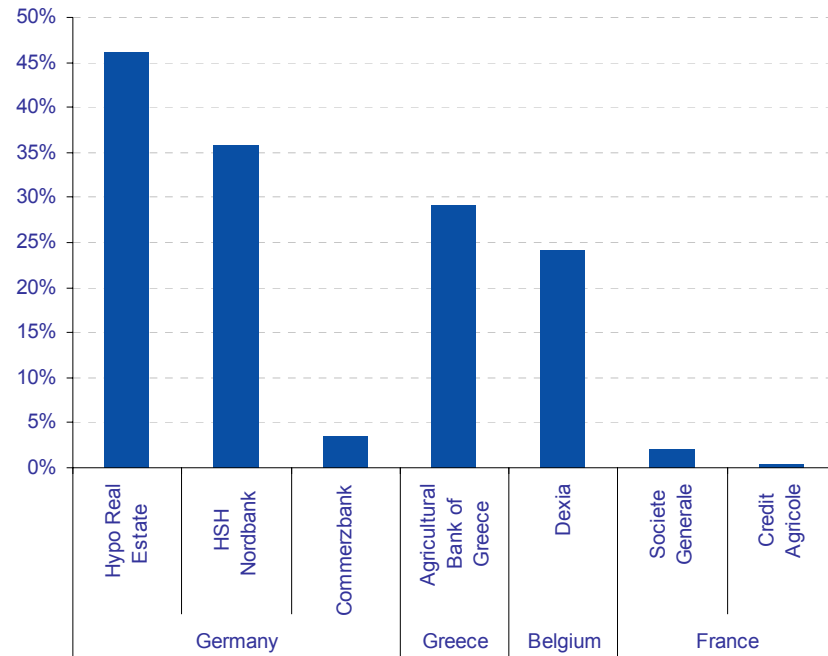
Solvency: What are banks' balance sheet problems?

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*

(% Assets, Jun-11)

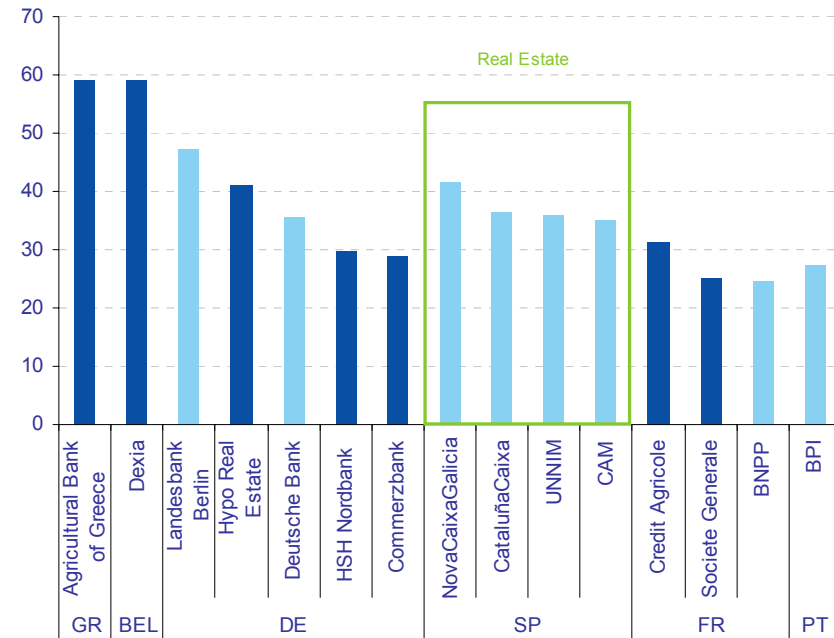
Source: BBVA Research based on Bloomberg



Leverage Ratio: Assets/Own Funds

(%, Jun-11)

Source: BBVA Research based on Bloomberg



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

Section 2

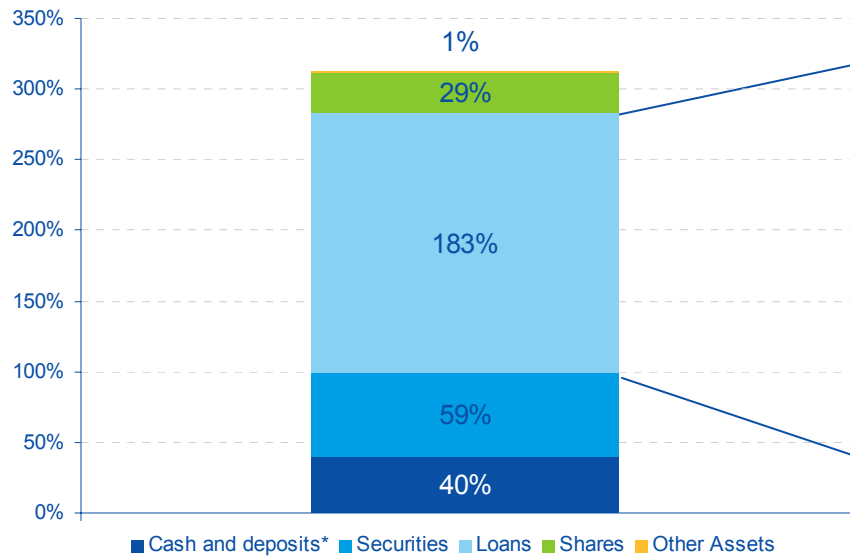
Solvency: In Spain, concerns are concentrated in real estate

Problems are concentrated on the exposure to the real estate sector

Spanish Financial System: Assets

(%GDP, June-11)

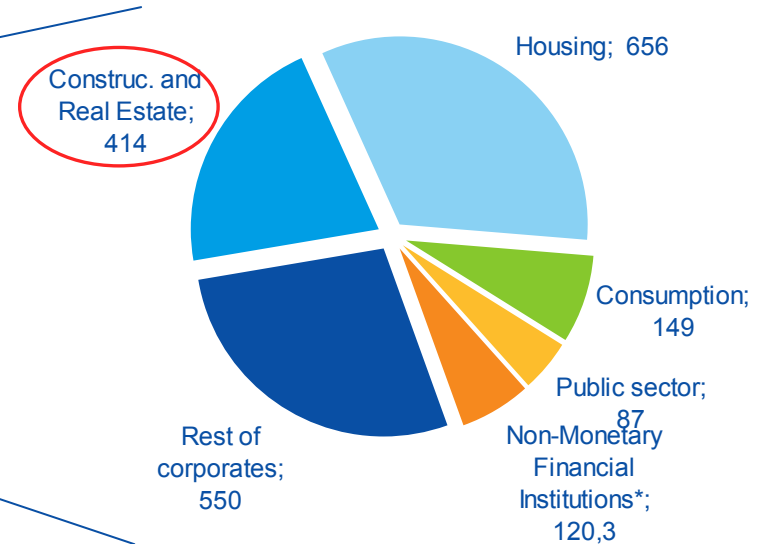
Source: BBVA Research based on Bank of Spain



Spanish Financial System: Loans

(EUR bn, June 11)

Source: BBVA Research based on Bank of Spain



*Including interbank credit

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

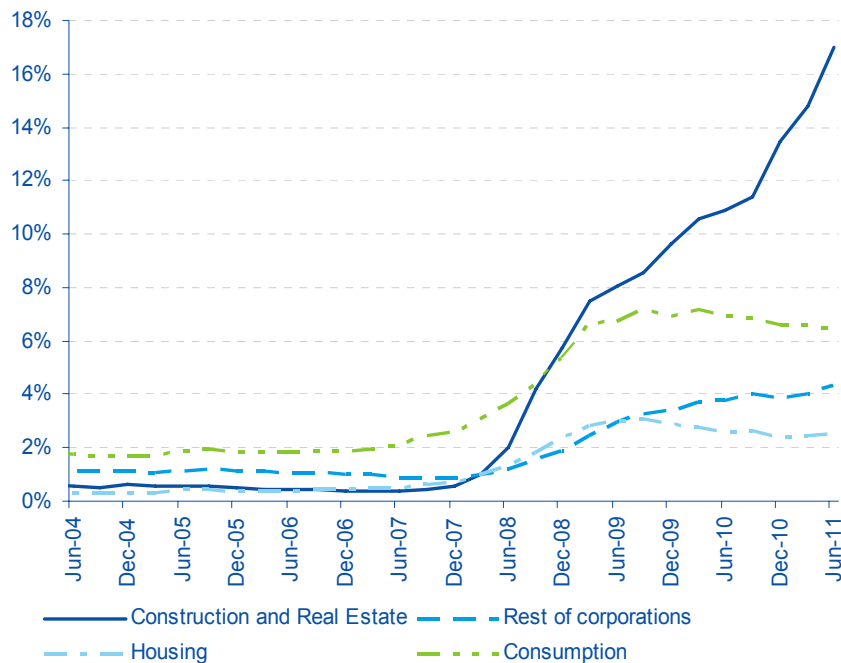
*Insurers, pension funds, issuers of asset backed securities...

Solvency: In Spain, concerns are concentrated in real estate

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

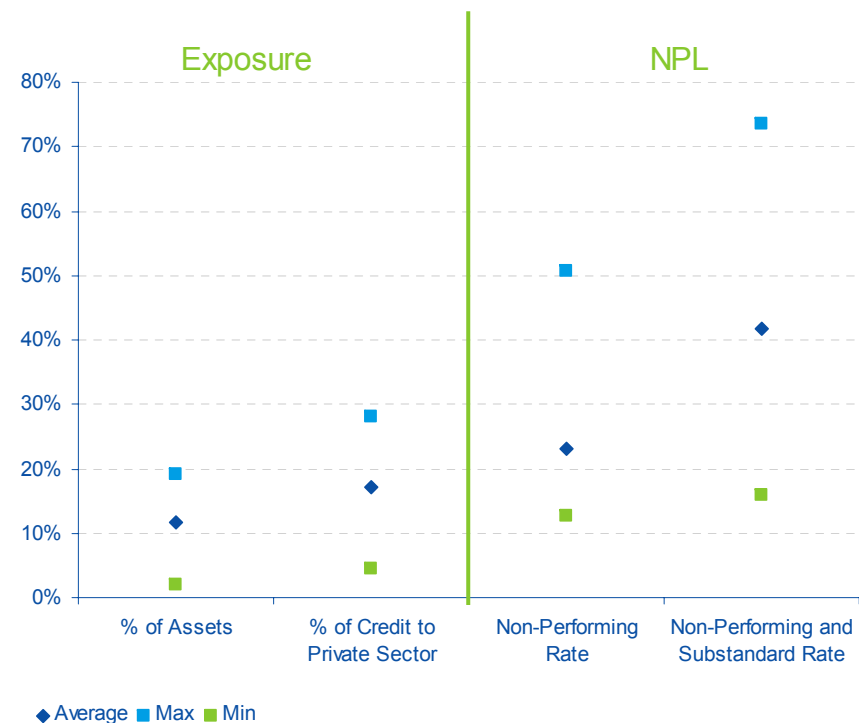
Non-performing loans

(% credit portfolio)
Source: Bank of Spain



Exposure to real estate & NPLs

(June 2011)
Source: BBVA Research based on CNMV



Solvency: wide range of estimates of capital needs

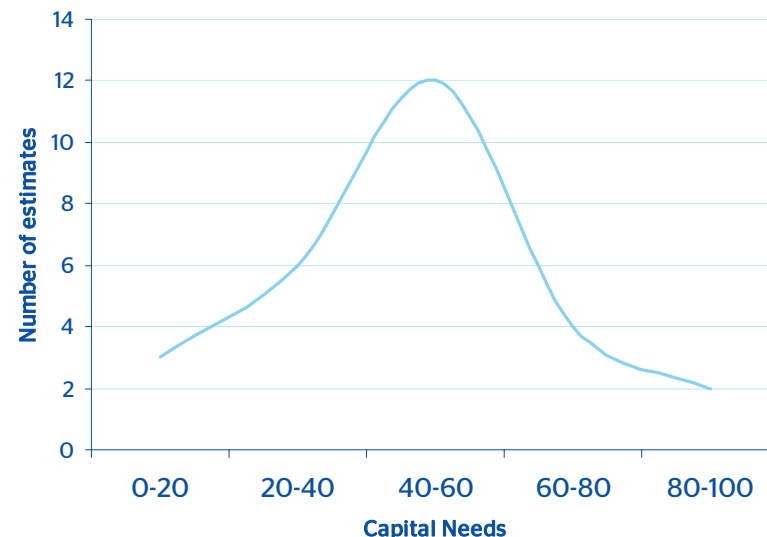
Diversity in estimates of capital needs (stress tests) ... but $\leq 10\%$ GDP

- 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.

Estimated capital requirements

(Total estimates used: 31)

Source: BBVA Research based on analysts' reports



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

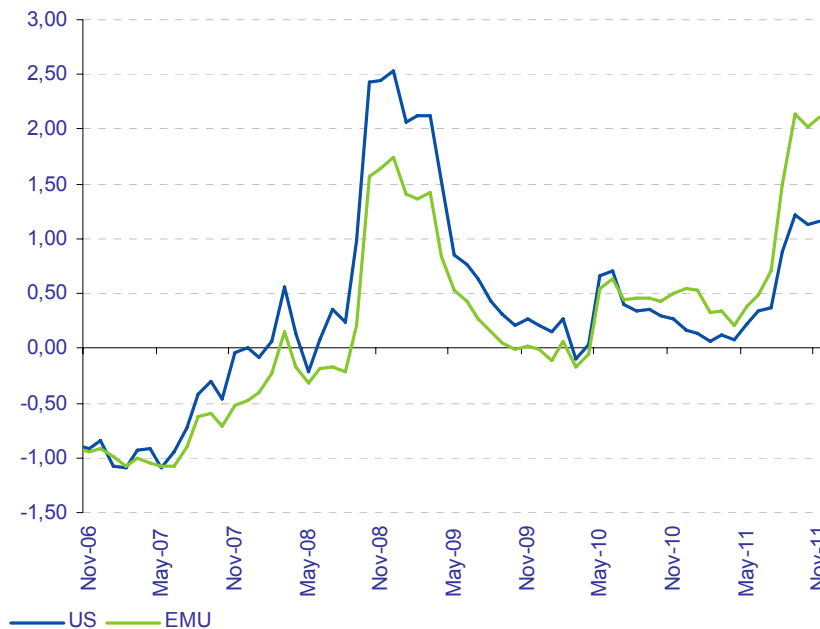
Section 2

Liquidity: The elephant in the room

Addressing liquidity problems in the euro zone is paramount.

BBVA Financial Tensions Index

Source: BBVA Research



- 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.

Section 2

Liquidity: The elephant in the room

Addressing liquidity problems in the euro zone is paramount.

EMU: Liquidity Tensions Indicator

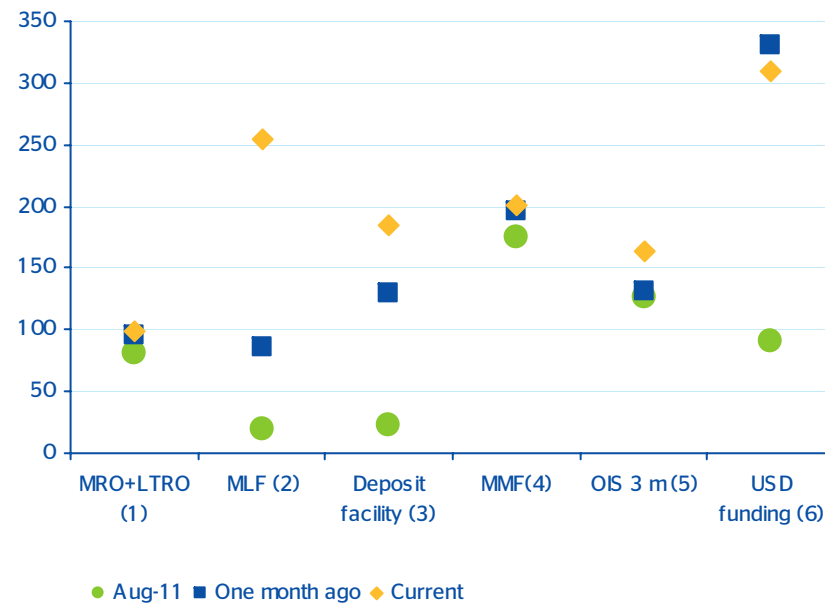
Source: BBVA Research



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

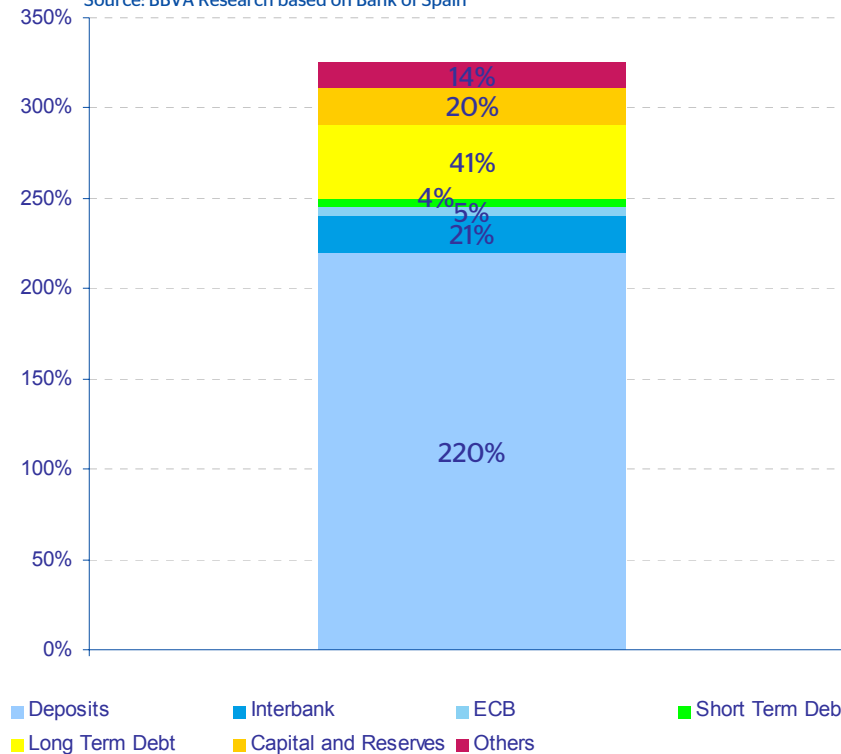
Liquidity: How does Spain fare?

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

Spanish Financial System: Liabilities

(%GDP, June 11)

Source: BBVA Research based on Bank of Spain



Section 2

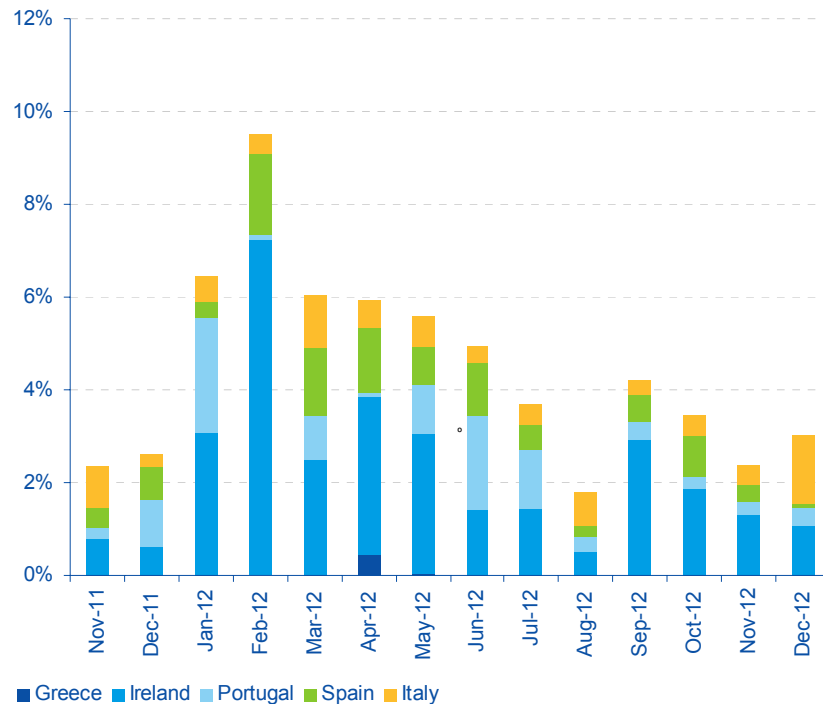
Liquidity: How does Spain fare?

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

Financial institutions: Debt maturities

(% GDP)

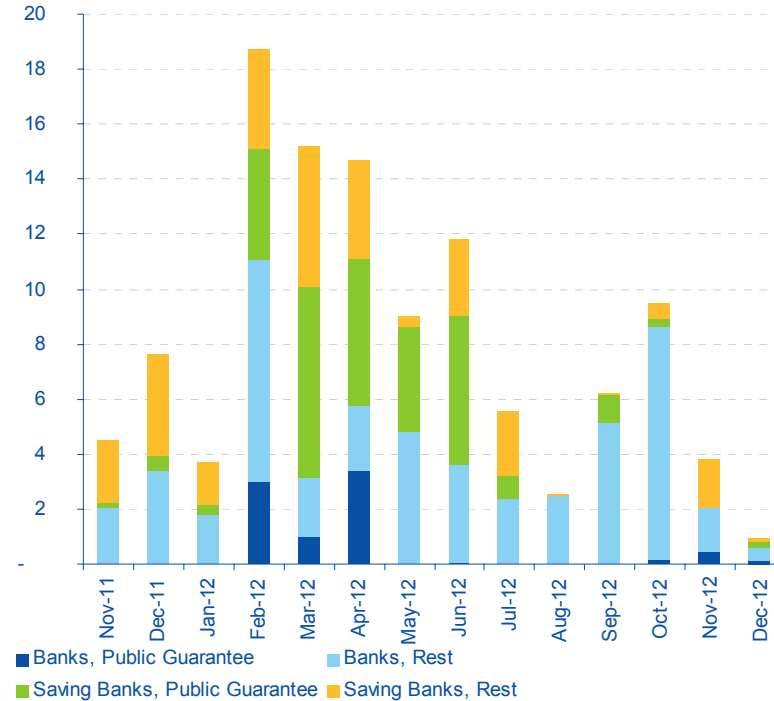
Source: BBVA Research based on Bloomberg, Dealogic and Bank of Spain



Spanish financial institutions: Debt maturities

(EUR bn)

Source: BBVA Research based on Bank of Spain



Section 2

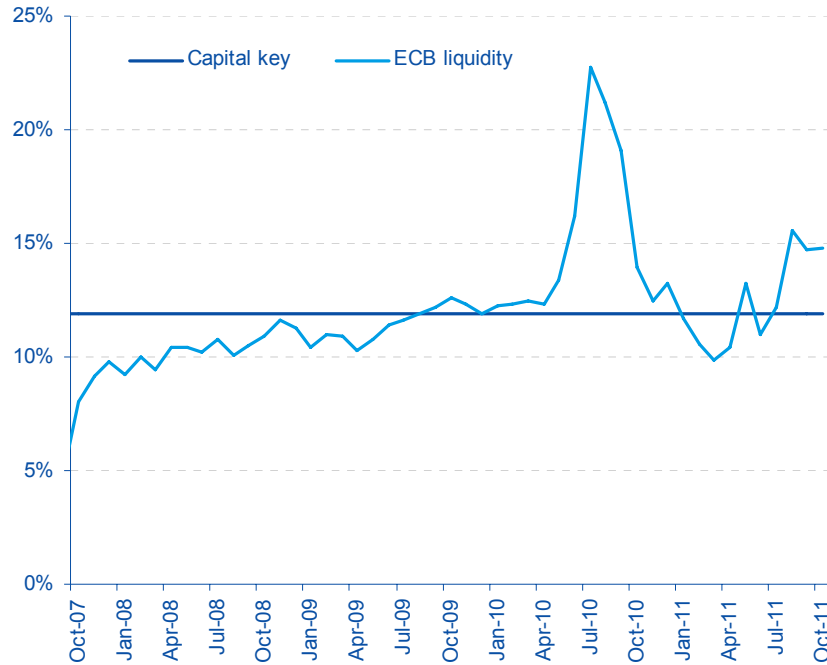
Liquidity: How does Spain fare?

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

ECB liquidity

(%total)

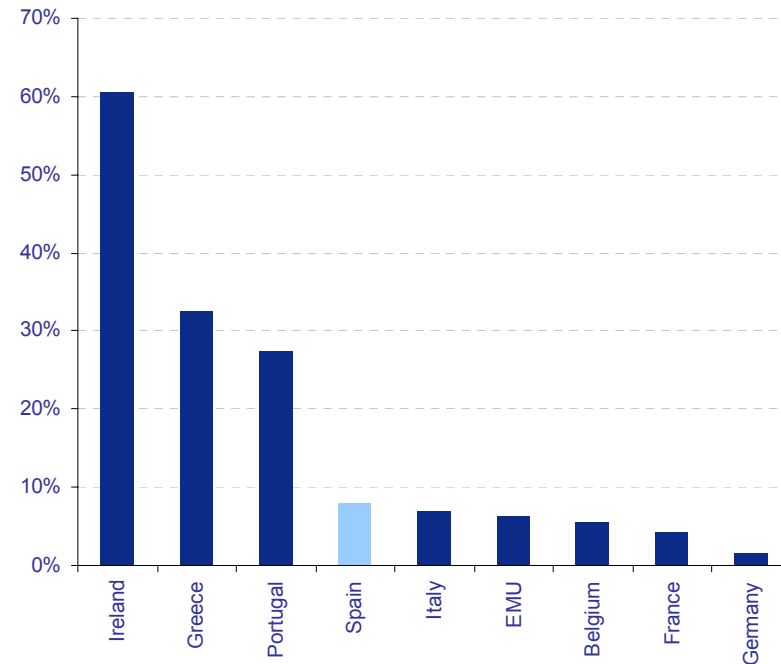
Source: BBVA Research based on ECB



ECB liquidity

(%GDP, Oct-11)

Source: BBVA Research based on Bloomberg



Section 2

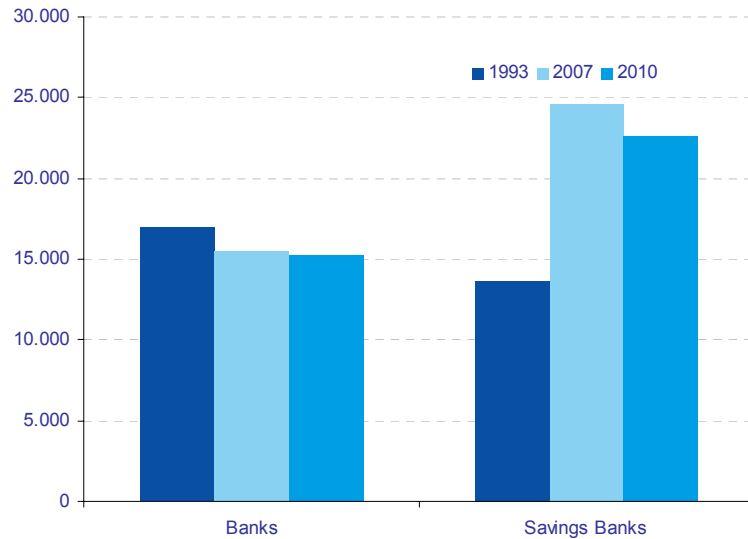
The restructuring process

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

Number of branches

(Number)

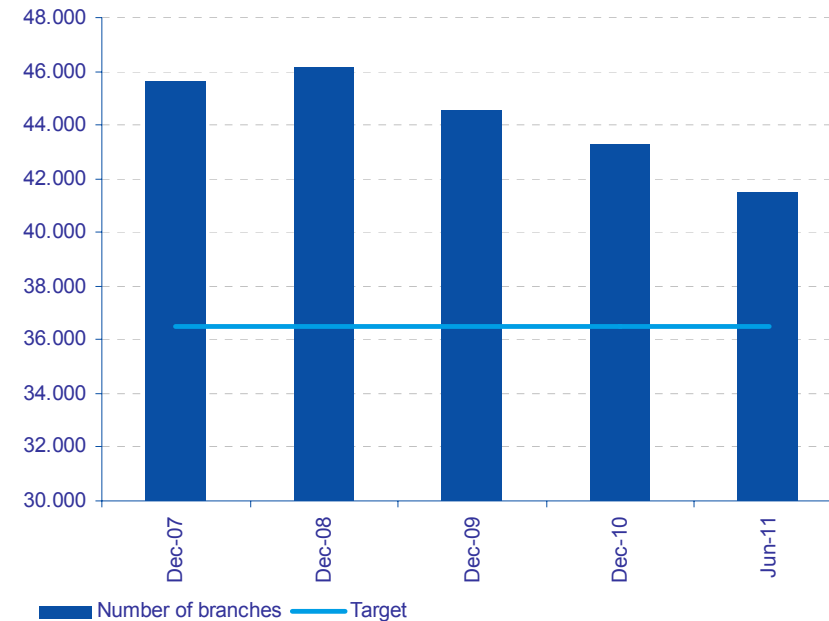
Source: Bank of Spain



Number of branches

(Number)

Source: BBVA Research based on Bank of Spain



Section 3

Next steps

Europe

Spain

Unfreeze liquidity constraints in euro area bank financing

A specific and truly comprehensive
Europe-wide stress test



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

