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Closing address

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Introduction

It is a pleasure for me to deliver the closing address at this Association for Financial Markets in Europe (AFME) conference.

Following the organisers' guidelines, I shall essentially be talking about the current situation of the Spanish banking system and its outlook for the year ahead. To do this, however, I must first refer briefly to the Spanish economic situation at the onset of 2014, a situation far different from that in early 2012.

Recent developments in the Spanish economy

In the opening months of 2012, and coming to a head in the spring and summer that year, Spain saw its external funding come to an abrupt halt. This phenomenon, although seen in the past in certain emerging countries, was a totally new experience for Spain.

Spain was able to emerge from this financing crisis thanks to the funds obtained by our banking system at the European Central Bank.

Spain had itself to blame for this, but the situation was also compounded by the markets' perception that the euro area was close to breaking up.

The current picture is totally different. Spain has turned the corner.

Just as the situation in 2012 was the result of European and Spanish sins alike, the current lie of the land is attributable to major policy measures both in Europe and in Spain.

Confining myself to the conduct of the Spanish authorities, I shall refer briefly to a number of key measures undertaken in the past two years.

In terms of public finances, the budgetary stability framework was significantly strengthened and various adjustment measures were adopted to contain the budget deficit. As regards structural measures, a reform significantly increasing labour market flexibility was approved. Finally, in the banking sector, intensive restructuring and recapitalisation were undertaken, as part of the financial assistance programme agreed with the European authorities.

These measures have contributed to correcting some of the Spanish economy's main imbalances. Particularly significant progress has been made in correcting the external imbalance and in restoring the competitiveness of the Spanish economy. Indeed, Spain's current account balance, which posted a deficit of around 10 % of GDP in 2007, is now clearly in the black. This figure partly reflects the fact that, in this period, the losses in competitiveness since the creation of the euro area have been recouped, a trend assisted by the containment of wage costs associated with the labour market reform.

Now, as I have mentioned before, the current picture is totally different. Spain has turned the corner. Growth has resumed, employment has stabilised, the balance of payments is running a current-account surplus and the interest rate on the Spanish sovereign is at an all-time low.

These facts - which are all positive - define, by contrast with 2012, a new situation. However, they should not be interpreted as meaning that the future will be bright. Actually, growth prospects of the Spanish economy will remain modest in the foreseeable future and unemployment still unacceptably high.

The situation of the banking sector

I will now turn to the banking sector.

The improvement in the economy which I have just described has also been extensive to the banking sector. Since mid-2012, the Spanish banking system has undertaken a far-reaching restructuring and recapitalisation process. The milestones along the way were established in the Memorandum of Understanding (MoU) agreed between the Spanish and European authorities in July 2012. These included most notably identifying each institution's capital needs on the basis of the results of a detailed asset quality review and bottom-up stress tests; the recapitalisation of banks with a capital shortfall; and the transfer of the problem real estate-related assets of these banks to an asset management company (Sareb). This reform programme further included various horizontal measures affecting the entire banking sector and its regulatory and supervisory framework.

The reports recently published by the European Commission, the European Central Bank and the International Monetary Fund highlight the fact that the objectives set in the MoU have been satisfactorily fulfilled on schedule and, consequently, the financial assistance programme has been successfully completed as planned. It was thus possible to declare the programme over on 22 January.

The effort expended has paved the way for the emergence of some positive signs, which have undoubtedly contributed to improving the perception of the Spanish banking sector's soundness.

Firstly, there has been a significant increase in the solvency levels of the sector as a whole. This increase is more marked for the so-called group 1 and 2 banks, which are those that required State aid for their recapitalisation. Notably, the solvency of these institutions has been strengthened not only by the financial assistance afforded to them, but also by the burden-sharing exercises, which entailed a significant reduction in the State aid required. As a result of this effort, the core capital ratio for the Spanish banking system as a whole stands at around 10.5 %.

Significant headway has also been made in cleaning up bank balance sheets and in lessening the risks arising from their exposure to the real estate sector. Contributing to this have been more demanding provisioning requirements and the segregation of the assets transferred to Sareb by the institutions that received State aid. As a result, the exposure net of provisions to real estate risks has fallen from €240 billion at end-2011 to around €100 billion at present.

The year 2013 also saw a clear improvement in the liquidity of Spanish banks and a progressive re-balancing of their financing sources. For one thing, diminishing tensions on the sovereign debt markets and improving confidence in the economy and in Spanish banks have enabled some of the institutions that did not have to be recapitalised at the time to raise funding once again on the wholesale markets during 2013. The beginning of 2014 even saw Bankia issuing 1 billion euros of five-year senior debt.

For another, retail deposits, which fell significantly during most of 2012, once again posted positive growth in 2013. The more favourable performance by deposits, combined with the deleveraging of the sector as a whole, has led to a narrowing of the retail funding gap, i.e. the proportion of total credit that banks can cover with deposits. That has enabled the reliance on less stable funding sources such as the wholesale markets to be reduced. At the same time, the Spanish banking system's recourse to Eurosystem financing has fallen significantly, declining by more than 35 % since end-2012.

Nonetheless, the financing and liquidity of the banking sector should continue to be closely monitored in the short and medium term, given that the situation in the euro area has still to fully normalise and the problems of financial market fragmentation, though less marked, persist.

The favourable aspects I have portrayed have helped improve market sentiment regarding the Spanish banking sector. Testifying to this are the share prices of the main banks, whose price-to-book value has increased significantly and stands above the European average for peer banks. This underscores the restored confidence in the quality of the assets on bank balance sheets and in the profit outlook for Spanish credit institutions.

However, the progress I have described should be viewed with caution, as the Spanish banking system continues to face major challenges ahead.

These include the weakness of the economic situation. As earlier stated, the information available suggests that the recent improving trend will continue, but the intensity of the recovery is still very moderate.

That said, the overall banking system's results moved back into positive territory in 2013, following the extraordinary provisioning drive made in 2012. This is confirmed by the results of the main listed banks, which recently disclosed their accounts for 2013 Q4. However, profit and loss accounts remain subject to downward pressures, stemming fundamentally from an environment characterised by low levels of activity and low interest rates. These downward pressures, which will be eased in part by lower provisioning requirements, make it necessary for banks to persevere with their cost-cutting efforts.

One of the main challenges for the Spanish economy and banking sector is the contraction in credit. The evidence at hand indicates that the contraction is largely due to demand-side factors, such as the ongoing deleveraging of the private sector, although some supply-side constraints might also be hampering the access of certain borrowers to credit, especially small and medium-sized enterprises. That said, the latest data show that credit is falling more slowly. It should also be emphasised that the ongoing deleveraging of the Spanish economy needs to be compatible with an appropriate re-channelling of credit flows to less indebted sectors or companies.

Lastly, among the challenges to the banking sector, I should also highlight the trend of doubtful assets in lending to the private sector. In recent quarters their volume has continued to rise and the doubtful assets ratio has stood at over 13 % for the industry as a whole, increasing across the board for all sectors of activity. If the usual lag between the business cycle and the behaviour of doubtful assets is taken into account, the doubtful assets ratio may be expected to continue rising for some time yet. Nonetheless, it should be borne in mind that the recent increase in this ratio is not due solely to the increase in doubtful assets, but also to the contraction in credit, which has been particularly marked in the case of banks subject to restructuring and resolution plans.

Regulatory measures

It would be remiss of me not to mention that certain regulatory and supervisory reforms since 2012 have likewise contributed to the improved banking sector situation.

Here, in addition to establishing a minimum core capital ratio of 9 % for all credit institutions, a new bank resolution and recovery framework has been created; improvements have been made in the field of transparency, requiring banks to publish detailed information on their exposure to the real estate sector and on re-financed and restructured loans; the reform of savings banks has been completed; and various improvements have been made to the supervisory framework. Allow me to set some of these measures out in greater detail.

One of the most significant areas of progress has been the reform of “cajas”. This reform, implemented through the Law 26/2013 on savings banks and bank foundations, represents a far-reaching restructuring of the legal framework for these institutions.

The new legislation introduces the concept of "bank foundations" to accommodate the legal treatment of the former “cajas” that have qualifying holdings (equal to or over 10 %) in banks. Various legal requirements and limitations are imposed on bank foundations in order to ensure and reinforce the independence of the governing bodies of the banks under their control. The legislation also establishes a series of incentives to reduce bank foundations' stakes in banks so that, over time, the former “cajas” may reduce their holdings in banks to levels below a controlling interest.

Major improvements have also been made to supervisory procedures, on the basis of a detailed report by an internal committee set up to this end in the Banco de España. However, for lack of time, I shall not set out in detail these changes in procedures.

I do however wish to highlight a related topic, namely the development by the Banco de España of a new supervisory tool to carry out prospective analyses to assess the solvency of Spanish banks under diverse hypothetical macroeconomic scenarios. This tool – called FLESB (the English acronym for Forward Looking Exercise on Spanish Banks) - will be subjected to a process of development and continuous improvement.

The FLESB – which is not designed to make projections of banks' capital ratios, but rather to assess the sensitivity of their solvency position to shocks - takes a macroeconomic scenario and uses it to calculate the expected loss in the loan portfolio for a certain time horizon. [Specifically, the expected credit losses for standard loans and doubtful loans at the beginning of the exercise, as well as the losses associated with foreclosed assets, are calculated. The macroeconomic scenario is linked to the expected loss through its impact on the probabilities of default and of recovery, and the value of collateral determined by the loss given default]. Next, these losses are compared with the bank's loss-absorbing capacity, including existing provisions, its ability to generate earnings under that scenario and the excess capital available.

The last edition of Banco de España's 2013 Financial Stability Report contained a summary of the results of the first run of FLESB using three different macroeconomic scenarios. A baseline scenario based on the Banco de España's projections, and two alternative scenarios with a lower probability of occurrence projecting more unfavourable behaviour of the main macroeconomic magnitudes for the period 2013-2015. The first of them envisaged a stagnation of GDP for the next few years, with unfavourable behaviour of key variables such as house prices and the unemployment rate. The most adverse and unlikely scenario amounted to the third recession since the outbreak of the crisis.

On the basis of these scenarios, the exercise was conducted for the 15 banks which participated in the 2012 stress tests. The results showed a solvency position in 2015 which is relatively comfortable in aggregate terms, since even under the most adverse scenario the loss-absorbing capacity exceeded the expected losses by some €30 billion. Moreover, although this tool does not enable the solvency position of individual banks to be estimated accurately, the results indicate that all the banks analysed comply with the minimum regulatory requirements even under the most adverse scenario.

Looking forward

The measures described give a good idea of the broad range of regulatory and supervisory actions already adopted in response to the main problems of the Spanish banking sector. However, significant challenges lie ahead.

Chief among them is the adaptation to the new international regulatory framework. One of the main features of this new framework is the prudential regulation set in place by the Basel III Accord, written into EU law by means of the Capital Requirements Directive and Regulation.

The content of the directive was transposed to Spanish law by Royal Decree-Law 14/2013, which includes the matters whose implementation was most urgent. The legislative procedure to adopt a law to complete the transposition has been launched already.

As you know, the application of the new rules will significantly raise the amount and quality of capital, which must be used effectively to absorb losses where necessary.

The new regulation provides for a progressive transition to these stricter requirements which will be completed in 2019. Although there is considerable pressure in the markets for banks to comply with all the requirements before the time limits set in the regulation, I consider that phase in arrangements foreseen in the regulation should be respected and full application of the new standards should not be imposed immediately, because in an environment of still-incipient economic recovery it could prove to be excessively pro-cyclical.

In any event, Spanish banks should take advantage of the leeway available to strengthen their own funds and build confidence in their ability to comply with the new requirements.

Another major challenge for the Spanish banking sector will be the start-up of the Single Supervisory Mechanism (SSM).

The implementation of the SSM poses a huge organisational challenge. So far the work is progressing briskly in important areas such as the internal organisation of the SSM, the preparation of a common supervisory manual, and the design and formulation of a comprehensive assessment of banks in the participating countries.

This comprehensive assessment exercise will include an asset quality review and a subsequent stress test to be conducted in conjunction with the European Banking Authority. It aims to strengthen confidence in the solidity of the European banking system by improving the transparency and enhancing the solvency of the banks which so require.

This exercise will be a major challenge for all European banks. In the case of Spanish banks, the headway in financial restructuring and the strengthening of their solvency position, along with the FLESB exercises of sensitivity to adverse economic scenarios that I just mentioned, lead us to believe that our banking system is in a reasonably sound position to face these tests.

Final observations

In short, the state of and outlook for the economy are much more favourable than they were just a year and a half ago. The banking sector has undertaken an unprecedented process of restructuring and recapitalisation. These advances have been clearly mirrored in the improved market sentiment towards Spanish banks.

Naturally we must remain prudent. Challenges and uncertainties still lie ahead for the banking sector.

But the fact is that a corner has been turned. And this allows us to maintain our confidence in the capacity of the Spanish banking system to successfully see through the restructuring process and to emerge in a stronger position to fulfil its mission of providing financing to the economy.

Thank you very much for your attention.