

Research

The Spanish banks

- This is the second paper in a series on the Spanish economy. The first paper is *The Spanish recession*.
- Spanish banks have suffered relatively small losses during the financial crisis because they invested very little in American sub-prime assets. But their exposures to the domestic housing market and Latin America pose a risk.
- Spanish banks generally hold a better quality of assets than their European counterparts. Thus their expected losses are smaller, and with their larger reserves they are in a better position to sustain any further losses.

We don't expect their balance sheets to deteriorate to an extent that would need much recapitalisation. We therefore anticipate the total amount of recapitalisation for the sector to be small.

Banking sector asset risks

Spanish leverage in the private sector has ballooned in recent years. Spanish banks have acquired more assets and increased their liabilities in the process. There is a potential risk of rising non-payments of loans, which could amount to significant losses for the banks. In this section we briefly explain the major risks that the Spanish financial sector is facing domestically and abroad.

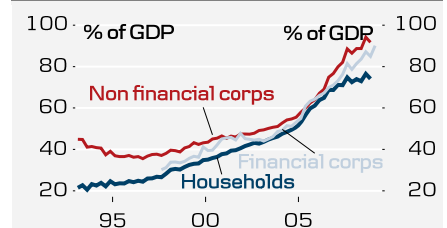
Domestic assets

In the *Financial Stability Report of November 2008*, the Bank of Spain makes an analysis of the balance sheets of Spanish banks and looks at troubled asset classes. The report concludes that the financial sector of Spain is relatively sound compared with those in America and other European countries.

Like the rest of Europe, Spanish mortgage laws prescribe that if non-payment of mortgage debt occurs, it is not sufficient to simply hand over the mortgaged asset. Instead the borrower is further liable to repay the remainder of the outstanding mortgage and therefore could lose other assets. This naturally reduces risk in the market and is in sharp contrast to the US mortgage market where the lender is only liable for his own collateral.

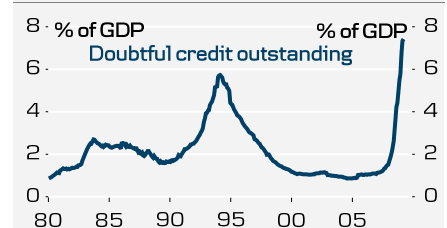
The Financial Stability Report also outlines a basic stress test in which it concludes that Spanish banks should be able to sustain a troubled asset ratio up to the level of 7-9% of GDP, which is the threshold level. In Spain's last economic crisis in 1993 the ratio was 4% of GDP. Currently the level is now 8% of GDP. The reason that Spain can sustain large losses is that its banks in general have a larger shield in reserves and are therefore better equipped for the crisis. Spanish banks generally also hold better asset classes than comparable banks in Europe and the US.

Leverage increasing in all sectors



Source: Ecwin

Debt repayment more uncertain



Source: Ecwin

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The Bank of Spain compares the current crisis with that of 1993. But the two crises are fundamentally different. In 1993 Spain experienced very high unemployment of nearly 25%, but only a 5% decline in house prices – a decline of that size has already been reached this time round. Furthermore, the global climate is worse now than in 1993 and a global recovery is still at an early stage. At the same time Spain isn't enjoying the convergence to lower eurozone rates as it was in the 1990s, and it has huge trade balance problems and significant foreign debt.

A stress test of Spanish banks

The IMF has made a more recent analysis *Spain: Selected Issues - IMF Country Report No. 09/129* based on more recent macro data and not the same internal information that the Bank of Spain has access to. The IMF forecasts that non-performing loans (NPLs) will amount to 6.3% of the total portfolio by end-2009, and it constructs an alternative housing downturn scenario with an NPL ratio of around 10%. The alternative scenario is based on a similar experience to the Scandinavian housing and banking crisis of the early 1990s.

To predict the losses, the IMF states a value of loss given defaults (LGD) based on research by other authors. These authors find that LGD is 20% for mortgages, 45% for construction and real estate, and 40% for other loans. They moderate these estimates to take into account the fact that the estimates cannot be based on retrospective studies because the magnitude of the current financial crisis is greater than any Spain has experienced so far. The IMF increases each LGD estimate by 5 percentage points so it is 25% for mortgages, 50% for construction and real estate and 45% for other loans.

The IMF stress analysis points to potential recapitalisation of domestic banks because they cannot recover all their potential losses from only increasing their interest margins. The scenario of NPLs based on a similar housing market and banking crisis as in Scandinavia implies required recapitalisation funding from the government of 0.1-0.3% of GDP – depending on the level of loss given defaults. Furthermore, this could result in lending being reduced and consumers experiencing a credit squeeze, which along with a higher interest margin, would harm the already credit-constrained consumers further.

Foreign assets

Another risk is foreign lending by Spanish banks. The Spanish banks have so far been relatively untouched by sub-prime losses and have little exposure to the CEE financial markets. But the Spanish banks are heavily entangled in Latin America. The Spanish banks' gross outstanding loans in Latin America alone account for 25% of Spanish GDP. Thus, if the banks were to suffer big losses there it could be very costly. Latin America has been hit by the global crisis, and GDP has contracted sharply. The IMF outlook is bleak, but the region is performing relatively well compared to the developed countries in the eurozone. And the IMF projects that these countries will be growing again by 2010. There are other smaller risks such as currency which we don't consider very important at this stage.

IMF Stress test results

Scenario 1 (NPL less than 6.3%)

LGD-1: Recapitalisation 0.0 % of GDP

LGD-2: Recapitalisation 0.0 % of GDP

Scenario 2 (NPL less than 10%)

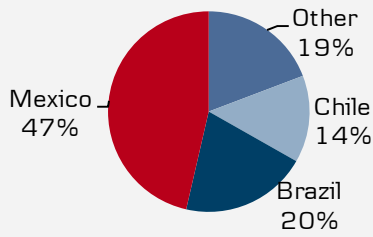
LGD-1: Recapitalisation 0.1 % of GDP

LGD-2: Recapitalisation 0.3 % of GDP

Source: *Spain: Selected Issues - IMF Country Report No. 09/129*

Spanish banks gross loan portfolio to Latin America

Total value: 260 bil. € - 25 % of GDP



Source: BIS-quarterly review

Latin America - severe economic deterioration



Source: IMF

The outlook

In conclusion, Spanish banks have weathered the global financial storm well so far and they have large reserves. But they are now very vulnerable both domestically and abroad. They are likely to need some recapitalisation, which could amount to 0.1-0.3% of GDP according to the IMF.

So far only a handful of small Spanish banks have failed. But the situation looks bleak for especially the small local financial institutions, the “cajas”. But overall, we believe the balance sheets of the Spanish banks look robust and can sustain the expected losses. We therefore project that they will only need recapitalisation equivalent of 0.1% of GDP.

The Spanish government approved the establishment of a EUR 9bn Banking Recapitalization Fund. The fund’s two key objectives are to facilitate the restructuring of the banking sector and strengthen financial institutions that have been weakened by the economic crisis. This is equivalent to recapitalization of 0.1% of GDP – in line with our projection.

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