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Spain: Extensive real estate adjustment poses threat on banks' balance sheets

- The savings banks restructuring scheme is expected to improve the soundness and the efficiency of the Spanish banking sector.
- Further correction in the real estate sector is expected to keep exerting pressure on the Spanish financial system.
- Sovereign debt tensions and uncertainty over the final cost of banks restructuring to the state create a negative feedback loop.

Excesses in the real estate sector during the last two decades have inflated Spanish banks' balance sheets. Real investment in housing surpassed 9% of GDP in its peak in 2007, second only to Ireland in the Euro area. Since the onset of the financial crisis, followed by the Euro area debt crisis, banks have been suffering due to the burst of the housing bubble and the adverse macroeconomic environment Savings banks, which represent about 40% of the banking system in terms of assets, were the weak link of the domestic banking system, mainly due to their highly concentrated risk in household loans, both for house purchases and consumption.

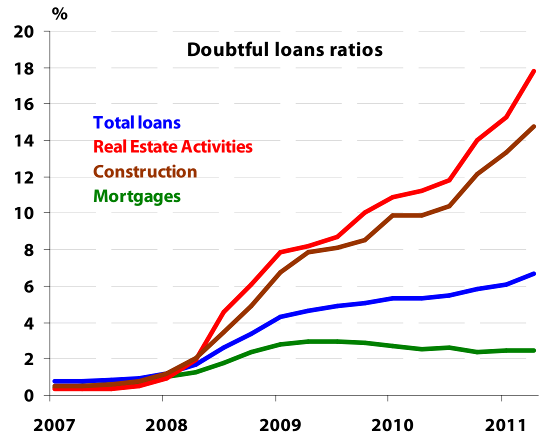
In 2009, the Spanish Government initiated a restructuring procedure centered on savings banks, in order to improve the soundness and the efficiency of credit institutions, increase their transparency, reduce overcapacity, improve corporate management and strengthen the capital adequacy of banks. The Fund for the Orderly restructuring of the Banking Sector (FROB) was created to manage the restructuring process and contribute to the reinforcement of capital position. Initially 45 savings banks have reduced through mergers and other integration processes down to 18. The fragmentation of the sector has been reduced as the average of total assets per institution has risen from €29bn to €72bn. Overcapacity has also been reduced as both the number of branches and employees has declined, by 10% and 5% respectively, since end-2008. The FROB has injected aid of €11.6bn in the process. In 2009, a new legal framework allowed savings banks to transfer their banking activities to commercial banks, thus making easier for the former to tap the markets for funding.

In early 2011, the government required all banks to achieve core Tier 1 level of at least 8% of risk weighted assets (elevated to 10% for those entities that rely on wholesale funding for more than 20% of total funding and less that 20% of their equity is held by third parties). According to Bank of Spain's calculations, thirteen banks (four commercial and nine savings banks) did not comply with the new solvency regulation and had to increase their capital by around €17bn (more than €14bn needed to be raised by savings banks). Institutions should first address markets to raise capital, resorting to the FROB if that proves not feasible. Recapitalization plans should be concluded by 30 September 2011 (with possible extensions granted by the Bank of Spain). Of the thirteen institutions, four savings banks have included in their strategy FROB funds as a primary option for recapitalization.

Despite serious efforts and wide reforms undertaken to restructure the Spanish banking system, uncertainty remains about the strength of the sector and the final cost of its recapitalization to the state, as FROB borrowing is state guaranteed. From 2008 to mid 2011, cumulative write-downs amount to €96bn (10% of GDP or 2.8% of banks' total assets). Moody's and Fitch estimate that in adverse conditions, the government aid to capitalize banks may reach €100bn, much higher than the Bank of Spain's estimations.

Real estate overhang stands out as the most important source of concern. Loans for construction and loans to real estate developers account for about 23% of total loans. Doubtful loans in these sectors are rising at an undiminished rate, raising fears about potential losses (Figure 1). According to the latest data (Q2 2011), doubtful loans for real estate activities and construction climbed to 17.8% and 14.7%, respectively. Real estate activities represent 45% of total doubtful loans. The Bank of Spain claims that for savings banks, 46% of total lending to construction and real estate development firms is potentially troubled.

Figure 1



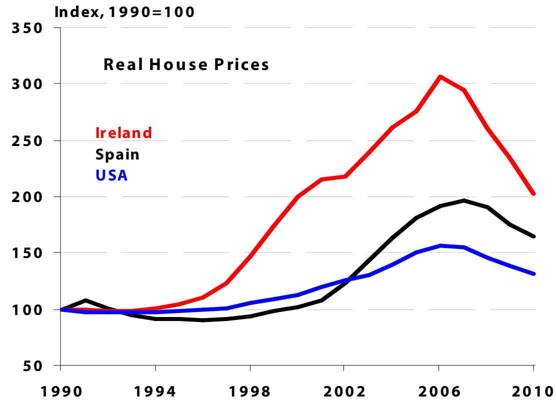
Source: Bank of Spain

Notably, mortgage loans (33.7% of total loans) are burdened with a relatively low doubtful ratio. As most housing loans are floating rate, households are expected to benefit from the ECB's pause in its tightening cycle. However, weak economic activity and severe labour market conditions form a negative backdrop for mortgage loans.

Real house prices have fallen by about 17% cumulatively, since their peak in 2007 (Figure 2). Housing market will most likely experience further correction, exerting further pressure on banks balance sheets. Besides doubtful loans, bank assets include a large amount of repossessed real estate assets from developers who fell in distress (Figure 3). There is uncertainty as to what their true valuation is, while they are expected to be hit by falling prices.

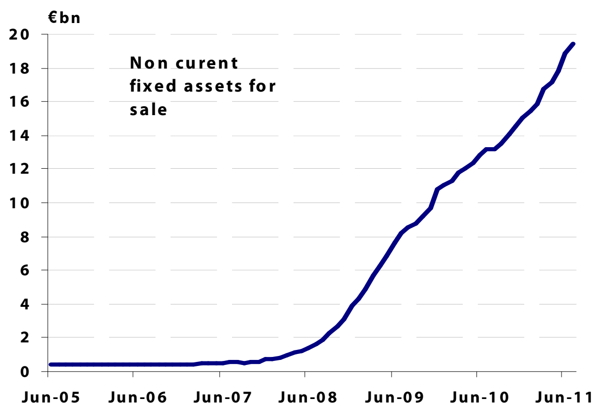
On a positive tone, the July 2011 stress tests, which represented 95% of the financial system, revealed that all financial entities were successful in achieving core Tier 1 ratio above 5% in the adverse scenario, if all provisions and capital recently raised are taken into account. According to the tests, the largest source of impairment (cumulative for 2011-2012) in the adverse scenario stems from exposure to the real estate sector (Figure 4).

Figure 2



Source: OECD

Figure 3

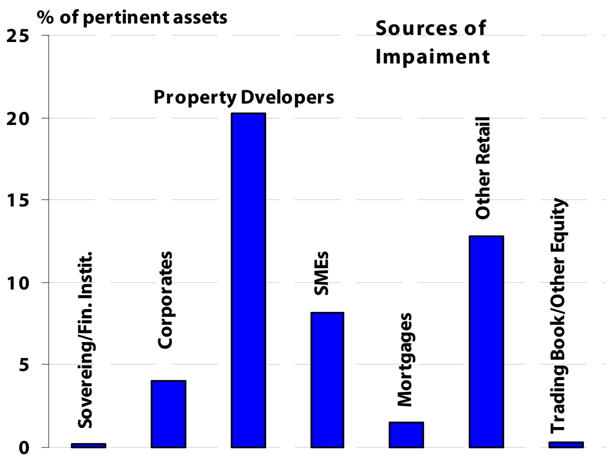


Source: Bank of Spain

The adverse scenario stress test envisages a decline of 34.2% in real house prices from 2008 to 2012. In our view, this is a rather strict assumption. House prices in Ireland have suffered from a similar decline, namely 39% since the burst of the bubble. However, the housing sector in Ireland has witnessed a much larger appreciation of the order of 200%, while in Spain the equivalent magnitude is half. In this perspective, Spanish banks seem to have fared well in the stress tests.

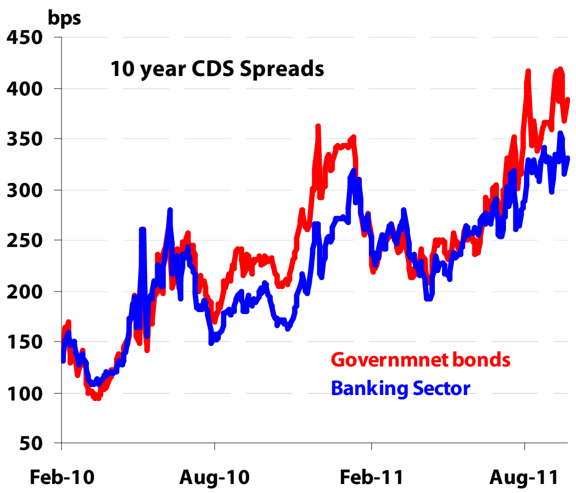
Tensions due to the euro area debt crisis affect adversely Spanish banks (Figure 5). Gross exposure to Spanish and foreign sovereign debt amounts to 6.91% of total assets (while the trading book figure declines down to 0.34%). Spain remains vulnerable to contagion due to anaemic growth, which raises doubt on the country's ability to put its public finances on a sustainable path. In addition, low quality banking assets raise fears on the soundness of the banking sector and the possible aid the state needs to inject in the system, creating a negative feedback loop between potential write-downs and government bond spreads.

Figure 4



Source: Bank of Spain

Figure 5



Source: Bloomberg

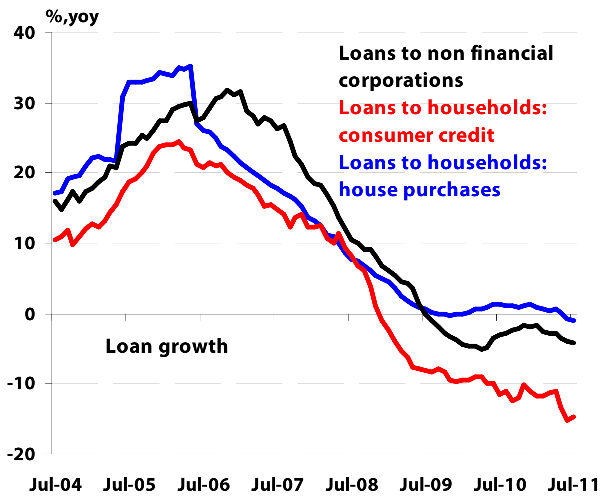
Note: Banking Sector CDS is the weighted average of respective CDS for Santander, BBVA and La Caixa.

Against this backdrop, wholesale funding has become expensive and Spanish banks depend heavily on ECB as lender of last resort. ECB borrowing reached €140bn in July 2010, followed by a rapid decline thereafter. However, dependence on the ECB rose substantially again since the summer, as the debt crisis intensified and contagion spread to Italy (Figure 6). Yet, Spanish banks' borrowing from the ECB in July stands at 2.4% of total assets, as opposed to 19.2%, 7% and 7.8% in Greece, Ireland and Portugal, respectively. Net interest income of the Spanish banking sector has been declining since Q2 2009. This trend is likely to continue as refinancing conditions are expected to remain tight due to the lingering debt crisis tensions. Moreover, in an adverse economic environment credit growth has stagnated (Figure 7), also affecting adversely interest income.

Figure 6

Source: Bloomberg

Figure 7



Source: Bank of Spain

Overall, the impact of the real estate overhang on financial system is by no means resolved. As a result, uncertainty will remain on the total amount the state has to inject in the banking sector. Nonetheless, the restructuring process of the savings banks has added to the capital adequacy and soundness of the sector. Enhanced transparency, costs savings and reduction of overcapacity due to the consolidation process should render funding cheaper and favor banks' profitability.

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